CLERK'S FRE COPY

(R-2003-390)

RESOLUTION NUMBER R- 297335 ADOPTED ON NOV 1 8 2002

RESOLUTION OF THE CITY OF SAN DIEGO AGREEING TO DEFEND, INDEMNIFY AND HOLD HARMLESS THE MEMBERS OF THE BOARD OF ADMINISTRATION FOR THE SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM IN THE PERFORMANCE OF THEIR DUTIES

WHEREAS, section 141 of the charter for The City of San Diego (Charter) created the San Diego City Employees' Retirement System (SDCERS); and

WHEREAS, Charter section 144 provides that SDCERS be administered by a thirteen (13) member governing board known as the Board of Administration (Board); and

WHEREAS, Charter section 144 and Article X, Section 7 sets forth the composition of the Board; and

WHEREAS, three members of the Board are elected by the General Members of SDCERS, one member is elected by the retirees of SDCERS, two members are elected by the Safety Members of SDCERS, one for Police and one for Fire, respectively, three members are ex officio and serve by virtue of their position as City Manager, City Auditor and City Treasurer, and four citizen members, one of which must be an officer of a local bank, are appointed by the Council and serve without compensation; and

WHEREAS, Charter section 117 provides that citizen members of the City's boards and commissions are deemed to be unclassified employees of the City; and

WHEREAS, Charter section 144 grants the Board the sole authority to determine the rights to benefits from SDCERS, administer SDCERS, and invest the SDCERS trust fund; and

WHEREAS, the Board Members may, from time to time be subjected to claims and suits for actions taken in their capacity as such; and

WHEREAS, there is a need to protect and encourage individuals who volunteer their time and their talent to serve in the public interest; NOW THEREFORE;

BE IT RESOLVED, by the Council of The City of San Diego that the City shall defend, indemnify and hold harmless all past, present and future members of the Retirement Board against all expenses, judgments, settlements, liability and other amounts actually and reasonably incurred by them in connection with any claim or lawsuit arising from any act or omission in the scope of the performance of their duties as Board Members under the Charter.

BE IT FURTHER RESOLVED, that in the event the City Attorney for the City of San Diego is unable or unwilling to provide such defense, the City shall pay for any and all costs and expenses of a Board Member related to such defense, which obligation it may satisfy in its sole discretion by engaging outside counsel at its sole expense.

BE IT FURTHER RESOLVED, that the City shall have no obligation to provide any defense or indemnification under this Resolution to any Board Member who: (1) fails or refuses to cooperate with the City Attorney or such other attorney who may be engaged to represent the Board Member; or (2) refuses to consent to a settlement (a) which does not require the Board Member to make any payment or perform any act; and (b) by which the settling plaintiff(s)/claimant(s) dismiss the Board Member from the complaint (if any) and generally release the

Board Member from all liability arising from the acts or omissions which are the subject of the

claim or lawsuit.

BE IT FURTHER RESOLVED, that nothing in this Resolution shall obligate The City of

San Diego to pay any portion of a claim or judgment against a Board Member for punitive or

exemplary damages.

BE IT FURTHER RESOLVED, that The City of San Diego will indemnify Board

Members for punitive or exemplary damages in accordance with the provisions of Government

Code section 825, only if the San Diego City Council, acting in its sole discretion, finds that:

(1) the claim or judgment is based on any act or omission of the Board Member acting within the

course and scope of his or her employment as such; (2) at the time of the act or omission giving

rise to liability, the Board Member acted or failed to act in good faith, without actual malice and

in the apparent best interests of the City of San Diego and/or the SDCERS; and (3) payment of

the claim or judgment would be in the best interests of the City of San Diego and/or the

SDCERS.

APPROVED: CASEY GWINN, City Attorney

Deputy City Attorney

MR:ms

9/19/02

Or.Dept: Retirement

R-2003-390

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REQUEST FOR COUNCIL ACTION CITY OF SAN DIEGO												NA		
TO: 2. FROM: (ORIGINATING DEPARTMENT LABOR RELATIONS								ENT) HUMAN RESOURCES				3. DATE 11/04/2002		
	4. SUBJECT													
Appr	Approval of agreements on SDCERS Board indemnification & City SDCERS Employer Contributions													
5. FOR INFORMATION, CONTACT: (NAME & MAIL STA.) 6. TELEPHONE NO. 7. CHECK HERE IF BOX 1472A, "DOCKET SUPPORTING INFORMATION," HAS BEEN													Image: section of the	
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8. COMPLETE FOR ACCOUNTING														
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												solution authorizing the	ne	
approval of an agreement (Managers Proposal II) between the City and the SDCERS Board.														
Approve the attached Resolutions														
12. SPECIAL CONDITIONS (REFER TO A.R. 3.20 FOR INFORMATION ON COMPLETING THIS SECTION.) ENVIRONMENTAL IMPACT: This activity is not a project and therefore exempt from CEQA guidelines, Section														
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CM-1472

LAST REV 3/00

DOCKET SUPPORTING INFORMATION

CITY OF SAN DIEGO

DATE:

11/04/2002

SUBJECT:

Approval of agreements on SDCERS Board indemnification & City SDCERS Employer Contributions

BACKGROUND:

Board Indemnification: Section 141 of the San Diego City Charter created the San Diego City Employees' Retirement System (SDCERS). Section 144 provides that SDCERS be administered by a thirteen (13) member governing board known as the Board of Administration (Board), which includes three members elected by the General Members of SDCERS, one member elected by the retirees of SDCERS, two members elected by the Safety Members of SDCERS, one Police, one Fire, respectively, three ex-officio members: City Manager, City Auditor and City Treasurer, and four citizen members, one of which must be an officer of a local bank, are appointed by the Council and serve without compensation. Charter Section 144 grants the Board the sole authority to determine the rights and benefits eligibility from SDCERS, administer SDCERS, and invest the SDCERS trust fund; SDCERS Board Members may, from time to time, be subjected to claims and suits for actions taken in their capacity as such. Due to the need to protect and encourage individuals who volunteer their time and their talent to serve in the public interest, approval of the resolution provides that the City shall defend, indemnify and hold harmless all past, present and future members of the Retirement Board against all expenses, judgments, settlements, liability and other amounts actually and reasonably incurred by them in connection with any claim or lawsuit arising from any act or omission in the scope of the performance of their duties as Board Members under the Charter.

Employer Contributions: On June 7, 1996, the City proposed and the SDCERS Board of Administration ("Board") agreed to the City Manager's Retirement Proposal, as modified, ("Manager's Proposal") dated July 21, 1996. The Manager's Proposal sets out agreements between the City and SDCERS with respect to contributions to be made by the City to SDCERS starting in Fiscal Year 1996. As a result of the recently concluded meet and confer process, the City and the Board recognize that under the current method of determining City contributions to SDCERS, the annual level of contributions has the potential to become volatile and SDCERS' funding ratio has decreased in recent years. The City and the Board also recognize that, under current fiscal circumstances, undue hardship would be imposed on the City if the Board were to require that the City immediately increase its contributions to the full projected unit credit rate calculated by SDCERS' actuary. In response to those concerns, on June 18, 2002, the City requested the Board agree to an amended Manager's Proposal. On July 11, 2002, the Board approved modifications to the Manager's Proposal. This Agreement is entered into in order to provide a transition period for City contributions to be brought, by fiscal year 2009, to the full contribution rates that would be applied if the projected unit credit funding method were used, to provide accelerated contributions by the City if SDCERS' funding ratio goes below 82.3% before the end of the term of this Agreement, and to terminate all transition arrangements regarding contributions with the City at the end of fiscal year 2009. The attached agreement describes the current and proposed contribution arrangements.

BY LINE: (CITY MANAGER / DEPT. HEAD / AUTHOR INITIALS)

SIGNATURES:

ORIGINATING DEPT. HEAD

CITY MANAGER

(FOR MANAGERIAL DEPARTMENTS ONLY)

SOBERT CAPTAR

GRAND, WEMPON

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SELTZER | CAPLAN | MCMAHDN | VITEK

A LAW CORPORATION

vitek@semv.com 619.685.3075 619.702.6204 fax

March 5, 2003

VIA HAND DELIVERY

CHARLES L GOLDIFAC FAIRICE O HALL MIGHACL A, LEGHT DANIEL A ANDRIST A SCOTT ACHITEK LEE C. HE JAJAHOWSKI DANIEL E ELIDA LAURA M. ROPPE CHRISTINE TENNISON ANDRIM D. BRODKI PAULA DAINDM 2044 P 101C4HO DARNIS 1. STEER TROY A LINGSHAVE CHARLET B. WITHAW JACKER) ACHORES
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San Diego City Employees'
Retirement System
410 B Street, Suite 400
San Diego, CA 92101

Sheila Leone, Esq.

San Diego City Employees' Retirement System, et al. adv. James F. Gleason, et al. - Initial Litigation Evaluation and Recommendations San Diego Superior Court Case No. GIC 803779
Our File No. 7835.56570

Dear Sheila:

Re:

DI COUNTEL
VICTOR A VRAFLANI
LINDA PAPEI EN ILOR
MONTY A MENITRE
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GRECORT A TEGA
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We have now had an opportunity to conduct an initial review and evaluation of certain documents pertaining to actions taken by the San Diego City Employees' Retirement System ("SDCERS"), by and through its individual board members ("the Individual Defendants") which serve as the factual foundation of the *Gleason* litigation. The categories of documents we have reviewed include:

ADMITTED IN HEW JEASET ONL!

- (a) The Gleason complaint;
- (b) Correspondence to and from SDCERS' fiduciary counsel regarding the 1996 City Manager's Retirement Proposal ("the '96 Agreement");
- (c) Memoranda from the City of San Diego City Manager's Office regarding the '96 Agreement;
- (d) Memoranda from the City Manager's Office regarding the City Manager's May 2002 contribution reduction proposal ("the '02 Proposal");
- (e) Draft and final correspondence, and presentation materials, from SDCERS' fiduciary counsel regarding the '02 Proposal;
- (f) SDCERS Staff Report regarding the '02 Proposal;

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Sheila Leone, Esq.
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March 5, 2003
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- (g) Correspondence and presentation materials prepared by SDCERS' actuary regarding the '02 Proposal;
- (h) Minutes of the SDCERS Board of Directors meetings on September 20, 2002, and November 15, 2002;
- (i) Transcripts of the SDCERS Board of Directors meetings on June 21, 2002, July 11, 2002, and November 15, 2002;
- (j) Agreement dated November 18, 2002, regarding Employer Contributions between the City of San Diego and SDCERS, including related resolutions regarding defense and indemnity of the Individual Defendants;
- (k) Draft report on the Mayor's Blue Ribbon Committee on City Finances, dated January 15, 2003, including SDCERS staff response, and final version of "Blue Ribbon Committee" report, dated February 11, 2003.

We have also interviewed SDCERS' actuary, Rick Roeder, and spoken briefly with its fiduciary counsel, Bob Blum, Esq. We will meet with Mr. Blum to discuss his knowledge of the facts involved in this case on March 13, 2003. Finally, we have performed preliminary legal research to familiarize ourselves with the law governing SDCERS' rights, duties and obligations regarding the conduct at issue in the *Gleason* litigation.

Based on the foregoing sources of information, as well as our informal discussions with SDCERS staff, this letter will provide you with our initial analysis and recommendations regarding the defense of SDCERS in the *Gleason* litigation. As you know, our engagement is limited to representation of SDCERS, and does not include any of its board members, whether such board members are among the class of Individual Defendants or not. Moreover, our analysis, conclusions and recommendations are made exclusively from our perspective as litigation counsel. While we understand the *Gleason* litigation implicates highly politicized issues, our analysis does not take such factors into account, and instead focuses solely on what we believe is the litigation strategy mostly likely to achieve the best possible result for SDCERS.

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Summary of Conclusions and Recommendations

Our conclusions and recommendations, as set forth in detail in this letter, are:

- 1. The Individual Defendants breached their fiduciary duty by adopting the '02 Proposal in its modified form because it resulted in a lower contribution obligation by the City, as well as an increase in vested liabilities, without any basis for accepting the City's contention that it would meet its increased contribution obligations in the final years covered by the '02 Proposal. It is unclear whether plaintiffs are asserting a breach of fiduciary duty by SDCERS, as contrasted with its Board.
- 2. The Individual Defendants subordinated SDCERS' interests to the interests of themselves, their unions, and the City.
- 3. SDCERS Staff should recommend to the Board that it exercise its right under the November 18, 2002 Agreement to "nullify this Agreement to the extent required by its duties established under the California Constitution..."
- 4. Notwithstanding the foregoing conclusions, SDCERS may be immune from liability for the acts alleged in the complaint under Government Code section 815.2. Depending on the strategy adopted after discussion between SDCERS and its litigation counsel, the initial responsive pleading may be a demurrer to the Complaint seeking dismissal of the action against SDCERS on the grounds it is immune from liability.
- 5. In the event it is necessary to answer the Complaint in the *Gleason* litigation, SDCERS should consider filing a cross-complaints against the City of San Diego and the labor unions whose leadership voted for the '02 Proposal, alleging a conspiracy between the City and Unions to cause the Board members to breach their fiduciary duties to SDCERS' members and their beneficiaries.
- 6. SDCERS should adopt a litigation strategy in the *Gleason* litigation designed to cause the City to honor its contribution obligations under the '96 Agreement.

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Summary and Analysis of the Facts

B. The '96 Agreement.

In or about June 1996, the City Manager proposed an "Employer Contribution Rate Stabilization Plan," under which contribution rates would be calculated using the projected unit credit (PUC) actuarial method, with specified contribution rates in the ensuing two fiscal years of 7.08% and 7.33%. Thereafter, the contribution rate would increase by 0.50% each year until the contribution rate reached the rate calculated on the basis of the entry age normal (EAN) actuarial method. Significantly, the City Manager's proposal specified:

"In the event that the funded ratio of the System falls to a level 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation...the City-paid rate will be increased on July 1 of the year following the date of the actuarial valuation in which the shortfall in funded ratio is calculated. The increase in the City-paid rate will be the amount determined by the actuary necessary to restore a funded ratio no more than the level that is 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation."

The City Manager's stated reason for presenting the "Rate Stabilization Plan" was the unanticipated fluctuations in the Employer's Contribution Rate under the projected unit credit actuarial method adopted by the City in 1992. Thus, all parties knew the City Manager's proposal was intended to effect changes to the retirement system for the benefit of the City.

The question of whether the Board would be discharging its fiduciary duties in adopting the '96 Agreement was submitted to fiduciary counsel for an opinion. Counsel noted that nothing in the proposal "changes the Board's discretion to adjust the actuarial assumptions on which the System is based as needed in order to insure the long term funding integrity of the System." Counsel concluded:

"Provided the City-paid rate in the [Plan] is not less than an amount substantially equal to that required of employees for normal retirement allowances as certified by the actuary, the Board will be acting within the discretion granted to the Board to

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administer the System and discharging its fiduciary duties set forth in Article XVI, Sec. 17 of the California Constitution."

In response to questions from members of the Board, fiduciary counsel issued a second opinion addressing the System's duties under Claypool v. Wilson (1992) 4 Cal.App.4th 646, and related cases, to ensure that the modification of vested pension rights which would result from adoption of the City Manager's proposal were "offset" by an "increase in benefits and other advantages granted to the beneficiaries" of the System. Counsel noted that other aspects of the City Manager's proposal conferred increased benefits on the System's members. This, combined with the conclusion that "stabilization of employer contribution rates is directly related to the functioning and integrity of the system, led counsel to conclude the Board was acting in a manner consistent with its duties under Claypool.

In its second opinion letter, fiduciary counsel addressed two additional issues raised by Board members, which remain relevant to the current litigation. First, counsel noted the Board is held to the standard of professional bankers and bank investment advisors, and therefore has "a duty to determine the financial viability of the City before it approves contribution payments at a level less than that recommended by the actuary." Failure to carry out this duty, counsel noted, would be a breach of fiduciary duty. After reviewing the available information, counsel concluded a process existed through which the Board could satisfy itself of the City's financial viability.

Next, counsel noted that, because "the Board has no authority to determine benefits or to make benefit changes," it "should not engage in negotiations for benefit changes or increases." Nonetheless, certain Board members inquired as to whether the "real conflict" presented by Board members voting on proposals which would confer financial benefits on themselves would prevent those Board members from voting on the proposal. Fiduciary counsel noted that the City Manager's proposal made adoption of increased benefits contingent on approval of reduction of the City's funding obligation. However, counsel noted the drafters of the City Charter through which SDCERS was established "were aware of possible conflicts of interest inherent in the appointment of those [financially interested] members of the Board." Under these circumstances, counsel opined, the "bare potential for a conflict of interest does not categorically bar a fiduciary from functioning as a trustee." On this basis, counsel concluded:

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"[I]t is our opinion that those Board members who voted in favor of the proposal solely in the interest of, and for the exclusive purposes of providing benefits to participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system, did not have a conflict of interest sufficient to bar him or her from functioning as a trustee."

According to Mr. Roeder, the performance of relevant financial markets during the 1996 through 2000 time frame caused the funding ratio to far exceed the "trigger" established by adoption of the '96 Agreement. Mr. Roeder noted it was generally accepted that the funding ratio trigger was 82.3%, but because the funding ratio never approached that level, certain potential ambiguities in the '96 Agreement were never resolved.

C. The 2002 City Manager's Proposal.

On June 10, 2002, the City Manager, on behalf of the Mayor and City Council, requested that SDCERS approve an amendment to the '96 Agreement as follows:

"The floor for the actuarial funded ratio of SDCERS will be established at 75%.

The City will pay contributions at the 'agreed to' rates for FY96 through FY07 as contained in the Manager's Proposal. If the actuarial funded ratio falls below the floor in any year, the City will increase its contribution rate on July 1 of the following year by an amount equal to one-fifth of the amount necessary to reach the full actuarial rate. The City will pay this increased amount for each of the subsequent for years in order to achieve the full actuarial rate over a five year period."

The City Manager identified as the basis for the proposed amendment several "unprecedented events" during the preceding two years, including 9/11, "the collapse of the dot com industry," the "overall fall in the investment market," the "specific loss of revenues in the San Diego economy, and the anticipated raid on local revenues by the State of California."

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During the following week, SDCERS requested an opinion from its current fiduciary counsel, Bob Blum, Esq., as to whether adoption of the City Manager's proposal was consistent with the Board's fiduciary duties. In an unsigned draft opinion letter dated June 12, 2002, Mr. Blum summarized the circumstances which led to the City Manager's proposal, including: the total of contributions by the City and members to SDCERS was insufficient to cover the normal cost and interest on past service cost computed at the actuarial funding rate; from July 1996 to June 2002, the difference between actual City contributions and actuarially calculated contributions totaled approximately \$90 million; and, "it is estimated that as of June 30, 2002, SDCERS funding ratio will be close to 82.3%."

Mr. Blum noted that since the '96 Agreement was executed, the law governing employees' interests in their retirement system had been "substantially strengthened," thus limiting the ability of employers to alter contribution obligations in a manner that affected vested benefits. Moreover, Mr. Blum noted that the ability to "mitigate" funding reductions through provision of "comparable new benefits" was "not governing with respect to the Board's responsibility to act prudently. If it were governing then each time that employer persuaded a Board to reduce contributions, it could avoid challenges by increasing benefits. That would not pass elementary actuarial requirements." Significantly, Mr. Blum noted that one of the questions left unanswered by the City Manager's proposal was the means by which the City would fund its contribution obligation under the proposed modification to the '96 Agreement.

After more than a dozen pages of analysis, counsel concluded:

"Under the facts as we understand them, and for the reasons discussed above, it is our opinion that there is a material risk that if the Board were to agree to the proposed amendment to the Manager's Proposal in its current form, and if this decision were challenged in court, a court would hold that the decision was not a proper exercise of the Board's fiduciary responsibilities based upon the facts before the Board and the actuaries [sic] opinion to the contrary. A court would look at whether the Board had substantial evidence to support the propriety of its actions and there is a material risk that a court would find such evidence lacking." (Emphasis added.)

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Also on June 12, 2002, SDCERS' actuary, Rick Roeder, made a presentation to the Board which was highly critical of the '02 Proposal. Among the most important points Mr. Roeder made were the fundamental inconsistency, from SDCERS' point of view, between the "enhanced benefits" aspect of the proposal, and the "contribution relief" aspect of the proposal. Mr. Roeder also laid out the following facts, which he felt were relevant to the Board's decision:

- (a) SDCERS' role should be largely independent of the setting of existing or potential benefit levels;
- (b) Existing benefits for City employees were not below average compared to other state and national public systems;
- (c) SDCERS is one of the few retirement systems to use PUC funding, and on that basis has one of the lowest funded ratios in California; moreover the existing funded ratio is at its lowest point since the 1980's; and
- (d) The gap between the computed PUC actuarial rate and the city contribution rate has been increasing since implementation of the '96 proposal.

Mr. Roeder also noted several mitigating factors. Foremost among them, it appears, was that SDCERS would "be able to make benefit payments over the next 10-15 years regardless of the decision made to grant potential additional funding relief."

In his presentation to the Board, Mr. Roeder stated, "What the City proposes is outside the norm for generally accepted actuarial funded policies," a circumstance which he felt "place[d] an added burden in our view as trustees to exercise our fiduciary responsibility appropriately." Mr. Roeder stated that if the Board was "willing to accept this version of the manager's proposal, I want everyone here to be totally cognizant of the fact that the way I understand the current version is it will [be] possible for the funded ratio to go below 75 percent and possibly significantly below." Finally, Mr. Roeder made clear he was more comfortable with the initial manager's proposal because of the "hard floor" of 82.3%

Transcripts of the June 2002 hearing indicate a difference of opinion existed among both Board members and Staff regarding the proper interpretation of the '96 Agreement's "catch-up" provisions; particularly, whether the entire underfunded

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amount came due in the immediately following year, or whether some longer term applied. Mr. Blum, along with Mr. Roeder, noted that under reasonably anticipated circumstances, a one-year catch-up provision would require the City to contribute approximately \$75 million in FY03, if the funded ratio fell below 82.3%, as it was expected to do.

On June 18, 2002, the City Manager issued a memorandum to SDCERS purporting to respond to concerns raised by Mr. Blum in his June 12 draft correspondence. There appears to have been no attempt to respond to Mr. Roeder's concerns as expressed in his presentation. Significantly, despite Mr. Roeder's concerns over "dropping the hard floor" from 82.3% to 75%, the City Manager's memorandum left that provision unchanged. Additionally, the City Manager responded to Mr. Blum's concern regarding "funding status and anticipated earnings" over the later stages of the '02 Proposal's life by stating:

"This is a very broad question which includes the work initiated by the Mayor's Blue Ribbon Committee on City Finances, the SDCERS subcommittee on surplus earnings and contingent benefits, and the need to develop a long term funding policy. It is recommended that a plan and schedule be developed to complete this policy work."

The only substantive modification to the original proposal was an increase in the City's "agreed contribution rate" from 0.50% to 1.00% effective July 1, 2004. This proposal is, at the very least, puzzling in light of the City Manager's non-response to Mr. Blum's questions concerning financing, and the City's purported justification for seeking contribution reduction in the first place, i.e., that it expected the State to "raid" City revenue sources beginning in 2004, thus worsening its short-term financial outlook.

On July 3, 2002, the City Manager provided SDCERS with another memorandum "clarifying" the terms of the proposal, as well as responding to concerns by Board members. Significantly, the City Manager's "clarification" made clear that the City had agreed to increased benefits for its employees during labor negotiations, "contingent" upon SDCERS accepting a reduction of its contribution obligation; yet in response to a Board member's question as to why SDCERS was placed in the middle of labor negotiations, the City Manager denied such a thing had occurred. Also significant was the City Manager's response to the Board's question of "why

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we should assume the City will find it easier to pay much higher pension costs in the future:"

"It will not be easier nor desirous, just necessary."

No further information was provided as to how the City would meet the contribution obligation outlined in its proposal.

On July 11, 2002, another Board meeting was held at which SDCERS' fiduciary counsel provided an analysis of the effect of the "changes" the City offered in an effort to gain acceptance of the '02 Proposal. Mr. Roeder made clear at the July 11 meeting that the 82.3% trigger would be hit in June 2003. Thereafter, the Board devoted its discussion to the difference in funding obligations between competing interpretations of the '96 Agreement and the '02 Proposal. After lengthy and detailed discussions, Mr. Saathoff proposed that the 75% trigger in the '02 Proposal be replaced with the existing 82.3% trigger. Additionally, the modified proposal would incorporate the provision in the original '02 Proposal giving the City five years after the trigger was hit to "reach the full actuarial rate."

In the final minutes of what was a very long meeting, before a vote was taken, the Board asked both Mr. Roeder and Mr. Blum whether adopting the proposal was "a prudent exercise of our responsibility." Mr. Roeder appears to have responded that the final version of the proposal fell somewhere between the '96 Agreement and the original '02 Proposal. Mr. Blum stated it was difficult to give "an on-the-fly opinion," before concluding:

"I can tell you it's a lot easier to give an opinion that you would not be at material risk. Exactly how far that opinion can go, exactly what the words are, that's a little difficult to tell you because we don't have the facts."

A vote was taken immediately thereafter, in which the modified '02 Proposal passed 8 to 2, with one abstention.

On November 5, 2002, Mr. Roeder provided certain written "statements in regard to the amendment to the Manager's Proposal." From the perspective of the current litigation, the most significant statements Mr. Roeder made were:

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- "(c) It is likely that the 82.3% trigger point will be hit by June 30, 2003,..."
- "(d) The higher the City's contribution levels, the better the funding status of SDCERS..."
- "(g) From a pure actuarial viewpoint, it would be best to hold the City to the existing Manager's Proposal and the 82.3% trigger (particularly if one of the two 'high contribution rate' interpretations of the effects of hitting the trigger were to prevail)."

Mr. Roeder's letter did not include any statement to the effect that adoption of the modified '02 Proposal conformed to generally accepted actuarial principles, or that it was a prudent exercise of the Board's fiduciary responsibility.

On November 15, 2002, Mr. Blum reported to the Board on the results of his negotiation with City representatives on the provisions of the Memorandum of Understanding that set forth the final terms of the modified '02 Proposal. The Board discussion centered on assumptions underlying the exemplar calculations in the Memorandum of Understanding. Additionally, the first mention was made of "indemnification" of the Board by the City from unspecified consequences of adopting the modified '02 Proposal. Transcripts of the hearing indicate the discussion became extremely contentious and acrimonious. It appears from both the minutes and transcript that the Board concluded Mr. Blum essentially supported adoption of the MOU because the Board had engaged in prolonged and difficult evaluation of the proposal before adopting it. However, at least one Board member acknowledged that Mr. Roeder was "hesitant" to endorse the proposal. Mr. Roeder confirmed this interpretation of his feelings, stating that he felt it was "inappropriate" and placed the Board in "a no-win situation" of evaluating a contribution relief proposal that was linked to enhanced benefits for members. Nonetheless, the Board voted to adopt the MOU.

On November 18, 2002, Mr. Blum provided SDCERS with a signed opinion letter, containing an extensive, albeit retrospective, summary and analysis of the Board's decision to approve the modified '02 Proposal. Mr. Blum summarized the Board's decision as follows:

"In essence, the Board decided to trade potential controversy over the meaning of the current Manager's Proposal and the possibility of receiving substantially higher contributions from the City if the

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82.3% trigger is met in exchange for materially higher contributions if the trigger is not hit, lower contributions in the first five years if the trigger is hit, a date certain when the full PUC rate is contributed, and agreement on rapid movement to EAN starting at the end of the transition period."

Despite Mr. Roeder's multiple criticisms of the '02 Proposal (see page 11), Mr. Blum's only mention of Mr. Roeder's analysis was that the "transition period of moving the City to full PUC rates and then to EAN rates is reasonable based on the terms of the Agreement." Mr. Blum's reference to this limited aspect of Mr. Roeder's overall conclusion is puzzling, since Mr. Roeder explicitly stated that "from a purely actuarial viewpoint," he preferred there be no transition period.

On November 18, 2002, SDCERS executed the Agreement adopting the modified '02 Proposal. Significantly, the recitals included a statement that SDCERS recognized that "under current fiscal circumstances, undue hardship would be imposed on the City if the Board were to require that the City immediately increase its contributions to the full projected unit credit rate calculated by SDCERS' actuary." Also significant was a previously little-discussed provision allowing the Board to "nullify this Agreement to the extent required by its duties established under the California Constitution and no one shall have any liability for losses or costs on account of such action."

On the same date, SDCERS and the City executed an indemnity agreement, which provided "the City shall defend, indemnify and hold harmless all past, present and future members of the Retirement Board against all expenses, judgments, settlements, liability and other amounts actually and reasonably incurred by them in connection with any claim or lawsuit arising from any act or omission in the scope of the performance of their duties as Board Members under the Charter."

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Summary of the Litigation

D. The Complaint.

The Gleason litigation was filed by attorney Michael Conger on January 16, 2003. Plaintiffs are by two retired San Diego City employees, purportedly acting on behalf of an alleged class of similarly situated retired San Diego City employees. Defendants are the City of San Diego, SDCERS, and certain members of the Board of SDCERS, including Frederick Pierce, IV, John Torres, John Casey, David Crow, Mary Vattimo, Ron Saathoff, Terri Webster, Sharon Wilkinson, Dick Vortmann, and Ray Garnica (collectively: "the Individual Defendants").

The lawsuit alleges the City of San Diego violated certain sections of its Charter, as well as related sections of the City of San Diego Municipal Code, by failing and refusing to contribute actuarially appropriate amounts to SDCERS. Specifically, the lawsuit alleges "[t]he funding method adopted by CERS [sic] and the individual defendants is not one of the six approved funding methods permitted under the rules set forth by the Governmental Accounting Standards Board." The allegations focus primarily on the City's alleged violation of the cited provisions of its Charter and Municipal Code by failing to contribute funds to SDCERS according to the terms of the '96 Agreement, and thereafter obtaining a greater reduction of its contribution obligation through the adoption of the '02 Proposal.

The lawsuit seeks declaratory relief in the form of a judgment that the City violated the terms of its Charter and relevant provisions of its Municipal Code, and that SDCERS' Board and the Individual Defendants breached fiduciary duties owed to the plaintiff class. The lawsuit also seeks restitution from the City of San Diego of all amounts owed to SDCERS as a result of past violations (an amount estimated in the hundreds of millions of dollars), injunctive relief prohibiting further unlawful underfunding, money damages for retirement benefits which would have been paid to the purported plaintiff class but for the alleged violations, money damages from the Individual Defendants for damages proximately caused by their alleged breach of fiduciary duty, and removal of the Individual Defendants from the Board of SDCERS.

E. SDCERS Proposed Response to the Complaint.

The complaint makes clear that both the Individual Defendants, as members of the SDCERS Board, acted in their official capacity when they entered into the Agreement which is the subject of the *Gleason* litigation. For this reason, we think

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that both the Individual Defendants, and SDCERS, may be immune from liability for the conduct at issue in the complaint, pursuant to Government Code sections 820.2, 821, and 815.2, respectively. We are presently researching whether any exceptions exist to these immunity statutes based on the nature of the alleged misconduct. If no such exceptions exist, it may be appropriate to demur to the complaint.

Before making this decision, however, consideration should be given to whether it is in SDCERS' best interests to extricate itself from the litigation at this early stage. While this may seem on its face to be counterintuitive, the underlying reasoning is as follows. The plaintiffs' objective is primarily to obtain funds from the City, both in the form of past contributions which were "wrongfully withheld," and increased future contributions. To the extent the complaint could achieve this form of relief, SDCERS would benefit. If SDCERS were to extricate itself from the litigation at the pleading stage, it would lose its status as a party, and its ability to affect the outcome of the litigation, which likely will be accomplished through the mediation process. Of course, the litigation would proceed against the City; therefore, the potential benefit to SDCERS from a judgment in favor of the plaintiffs would not disappear should SDCERS successfully demur to the complaint. Nonetheless, as you are aware, not being present at the "mediation table" with the City can have serious adverse consequences for SDCERS.

By electing not to demur to the complaint, SDCERS would not lose its ability to raise the immunity statutes as a defense. Such statutes can be pleaded as affirmative defenses in an answer, and thereafter be used as the basis for a motion for summary judgment which could be filed in the event early mediation proved unsuccessful. We intend to discuss this strategic decision with you in further detail once you have had an opportunity to review this letter.

F. Post-Demurrer Litigation Analysis

While we believe a reasonable probability exists that this matter could be dismissed as to SDCERS at the pleading or summary judgment stage, it nonetheless is necessary to advise you of our opinions as they relate to issues likely to arise in the post-pleading phase, should the case advance that far.

In the event the Court concludes SDCERS is not immune from liability, it will be necessary to answer the complaint and proceed with discovery. At the time the answer is filed, however, consideration should be given to filing a cross-complaint

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alleging conspiracy between the City and Unions to cause SDCERS' Board members to breach their fiduciary duties to its members and their beneficiaries. While this may seem antithetical to SDCERS' custom and practice in its dealings with the City, it highlights the significantly different circumstances forced on SDCERS by the filing of the *Gleason* litigation.

As we advised in the preceding section, SDCERS' interests arguably are aligned with plaintiffs' interests, at least to the extent that increased contributions by the City would benefit SDCERS. However, although SDCERS' interests are aligned with plaintiffs', its status as a defendant does not allow it to control the manner in which claims for such relief are prosecuted. For example, plaintiff counsel could settle with the City on the basis of ill-defined promises of future remedial action, combined with a large amount of attorney's fees for procuring such "relief." Under such circumstances, SDCERS would gain none of the advantage from the litigation to which it is arguably entitled. Filing a cross-complaint would confer standing on SDCERS to control the manner in which relief is sought, and potentially granted, rather than relying on plaintiffs to obtain all appropriate relief.

A cross-complaint against the City and Unions would be based on information that indicates certain union representatives obtained benefits for themselves and comembers of their union as part of the negotiation process over adoption of the modified '02 Manager's Proposal. If proven, this would support the conclusion that these individuals breached their fiduciary duty to SDCERS by approving a plan which included enhanced short-term benefits for themselves, while at the same time allowing the City to reduce its contribution to SDCERS.

Our recommendation in this regard also results in part from our conclusion that SDCERS Board members breached their fiduciary duty by executing the November 18, 2002 Agreement. As you are well aware, the California Constitution requires SDCERS Board members must discharge their duties for the exclusive purpose of providing benefits to participants and their beneficiaries, while also minimizing employer contributions and defraying reasonable expenses of administering the system. However, where these objectives conflict, the duty to participants and beneficiaries takes precedence over any other duty. Based on our analysis of the available information, we believe a trier of fact would conclude that the only party to the November 18 Agreement that obtained any benefit therefrom was the City, in the form of long-term contribution relief. All available actuarial analyses show SDCERS will receive substantially less money under any version of the '02 Manager's Proposal, when compared to the '96 proposal. Parenthetically,

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we believe the justification for adopting the '02 Proposal based on avoiding "uncertainty" over the terms of the '96 Agreement is insufficient to justify adoption of the '02 Proposal. Regardless of which interpretation was applied to the '96 Agreement, if SDCERS stood to gain between \$25 and \$75 million based on what its actuary and fiduciary thought was a reasonable interpretation of the '96 Agreement, it is difficult to accept the proposition that an "advantage" was gained by agreeing to a proposal that not only abandoned the arguable right to a \$25 to \$75 million contribution, but locked in a significant reduction in contributions over the following 8 years.

In addition to agreeing to a reduction in the City's contributions, SDCERS Board members accepted the November 18 agreement knowing its acceptance was a prerequisite to the City's agreement to pay increased benefits to certain of its unions. Thus, the Board agreed to a proposal that not only increased the vested benefits for which it was or would become liable, but at the same time impaired SDCERS ability to meet those obligations by accepting a reduced contribution obligation by the City.

Further on this issue, there appears to have been only limited inquiry into the means by which the City would ramp up its contributions over the term of the November 18 Agreement to meet the "agreed" contribution rate by 2009. The record shows the City sought contribution relief because of the near-certainty that the 82.3% funding ratio trigger would be hit by June 2003. Moreover, the City provided further justification for the requested contribution relief in the form of statements to the effect that its revenue in 2004 would be even less than in 2003, by virtue of the State "raiding" the City's revenue sources to pay for its own budget deficit. As SDCERS' fiduciary advised it when the '96 Agreement was adopted, the Board members are held to the standard of a professional banker, and must evaluate the financial condition of the City, before agreeing to grant it what amounts to debt relief. Yet here, the City offered no information to support its contention that it would somehow be able to contribute more to SDCERS between 2005 and 2009 than it ever had in the past, and thus reach the actuarially calculated contribution rate by 2009.

We anticipate that regardless of whether SDCERS prevails at the pleading or dispositive motion stage, and thus is no longer a party to the litigation, the foregoing facts nonetheless will come out in discovery. Our review of the record leads us to conclude little, if any, evidence exists that Mr. Roeder provided the necessary actuarial support for the Board's adoption of the '02 Proposal. Our

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interview with Mr. Roeder confirmed this conclusion. We anticipate that when plaintiffs depose Mr. Roeder, he will testify that the November 18 Agreement was not based on actuarially sound conclusions, and that it will result in substantially lower contributions by the City to SDCERS than would have resulted had the '96 Agreement remained effective.

We have not yet had an opportunity to interview Mr. Blum and Ms. Hiatt. Therefore, we have not been able to ascertain what substantive changes to the initial '02 Proposal convinced them to change their draft opinion, which stated adoption of the '02 Proposal would be a breach of SDCERS Board members' fiduciary duty, to their November 18 opinion, which appears to support the Board's decision. The absence of clear and specific facts supporting this turnabout leads us to conclude Mr. Blum's final opinion letter may be insufficient to protect SDCERS Board members from a finding that they breached their fiduciary duty.

Conclusion and Recommendations

The record we have reviewed clearly shows SDCERS was backed into a corner by the City, which agreed to provide enhanced benefits to its union members, and thereafter sought to "pay" for these benefits through reduction of its contributions to SDCERS. The City's enhanced benefits proposal to its unions was expressly contingent on SDCERS' agreement to reduction in the City's contributions. In essence, the City and unions forced SDCERS into precisely the circumstance its fiduciary counsel and actuary considered highly improper: linking benefit enhancement with contribution relief. Furthermore, the inherent and recognized conflict under which certain SDCERS Board members operate appears to have been exacerbated by the inclusion of additional benefits for those Board members during the negotiation process.

To avoid a continuation of this inherent conflict during our representation of SDCERS in the *Gleason* litigation, we recommend SDCERS form a litigation committee to direct its defense of this litigation. Our review of SDCERS' Charter indicates it cannot act without a quorum of its Board. In light of the fact the majority of its Board are Individual Defendants, and are separately represented, the composition of the litigation committee is a difficult question, and lacks clear precedent. Nonetheless, we believe the committee should be comprised of the Board president, at least one senior Staff member and Staff counsel, and Board members who have the fewest possible ties to either the City or the unions. This would allow a relatively "disinterested" litigation committee to make

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recommendations to the Board on important decisions to be made in defending against the *Gleason* litigation. In this manner, the influence of "interested" (and potentially conflicted) parties would be at least minimized, thus increasing SDCERS' ability to defend this action in a manner consistent with its Constitutional mandate.

If the "litigation committee" format proves unworkable, SDCERS may be able to adopt a course of action similar to that used by corporations defending against derivative lawsuits in which a quorum of disinterested directors cannot be assembled. In such circumstances, the corporation will sometimes hire a "litigation representative" whom it empowers to act on its behalf in directing and controlling the litigation. We have not yet researched whether SDCERS' rules of governance would permit it to designate an independent third party as its litigation representative in this action, but would be happy to do so if you so choose. Potential candidates for such a position would include retired judges such as Hon. Lawrence Irving, or Hon. Howard Wiener, or other individuals with an outstanding reputation for ethical conduct and business judgment.

In light of our conclusion that SDCERS Board members breached their fiduciary duty to its members and their beneficiaries by executing the November 18 Agreement, we believe it should adopt a litigation strategy designed to obtain an increased contribution obligation from the City. The first step in this process would be to exercise its right under the November 18 Agreement to "nullify" the Agreement. Thereafter, SDCERS should work with its actuary to produce a defined contribution schedule which meets SDCERS' obligations to its members and their beneficiaries in a manner consistent with other public agencies in this State. This actuarial calculation should then be used as the basis to obtain a new contribution agreement from the City in the context of mediation proceedings in this litigation.

We believe mediation is appropriate in this matter both because it would avoid a finding that SDCERS Board members breached their fiduciary duty to its members, as well as because we believe this will not be the last lawsuit Mr. Conger files as a result of the November 18 Agreement. As members of Staff have made clear to us, SDCERS has sufficient funds to meet its current obligations to the class of retirees. What Mr. Conger appears to not yet appreciate is that the November 18 Agreement compromised the interests of future SDCERS members much more than those of existing members. That is, from Mr. Conger's perspective, he has the "right" lawsuit, but the wrong plaintiff class. We suspect this fact will not be lost on Mr.

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Conger forever. In the meantime, the defendants enjoy a small strategic advantage in developing a strategy that would eliminate the potential for a second lawsuit on these facts while plaintiff counsel remains apparently unaware of the possibility of such a lawsuit. Developing a litigation strategy, as outlined above, that incentivizes the City to cooperate in reaching that goal is therefore of paramount importance.

As everyone is well aware, this is an extremely complicated matter, with ramifications reaching far beyond the limited scope of the *Gleason* litigation itself. We recognize that our analysis and recommendations may be inconsistent with SDCERS' political objectives, and we cannot offer any guidance on how to reconcile the two. Nonetheless, having been forced into litigation over what was originally a political and legislative issue, SDCERS must now formulate a litigation-based strategy for dealing with its current circumstances. After reviewing this letter, we would appreciate an opportunity to meet with appropriate SDCERS representatives to discuss this issue further.

Thank you for your attention to this matter. We look forward to hearing from you.

Very truly yours,

Reg A. Vitek Seltzer Caplan McMahon Vitek A Law Corporation

MAL/RAV:bs cc: Michael A. Leone, Esq.

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May 17, 2005 For Immediate Release Contact: Gail Stewart (619) 531-3790

District Attorney Files Felony Conflict of Interest Charges Against San Diego City Pension Board Members

San Diego District Attorney Bonnie M. Dumanis announced today that felony charges have been filed against six former and current members of the San Diego City Employee Retirement System Board of Trustees, following an 11-month investigation.

The six defendants, Ronald L. Saathoff, John A. Torres, Sharon K. Wilkinson, Cathy Lexin, Mary Vattimo and Terri A. Webster, have each been charged with three felony counts of Government Code 1090, which states in part that, "...city officers or employees shall not be financially interested in any contract made by them in their official capacity or by any body or board of which they are members." The felony charges carry a maximum sentence of three years in state prison.

"The legislature created Government Code Section 1090 to ensure good government," DA Dumanis said. "It requires that people in fiduciary positions may not serve two masters at the same time--when they act to the detriment of one or the other and it results in their financial benefit."

On July 11, 2002 The SDCERS Board of Trustees voted to approve and accept an amended version of a City of San Diego proposal which deferred a percentage of City of San Diego employer contributions and avoided the City's obligation to make a balloon payment to SDCERS as negotiated under the terms of a prior City agreement. The amended proposal included a negotiated enhanced retirement benefits agreement between the City of San Diego and three of the City of San Diego Employee bargaining unions.

These unions included the San Diego Fire Fighter's Local 415; Municipal Employees Association; and American Federation of State, County and Municipal Employees Local 127. Each of the trustees named in this criminal action voted in favor of this proposal and personally benefited as a result of their involvement with the amended proposal.

After the vote, Saathoff's monthly pension increased by \$2,530.23 to \$9,703.66; Torres' monthly pension increased by \$386.52 to \$4,016.81; Wilkinson's monthly pension increased by \$477.60 to \$5,096.26. Assuming that the other three defendants retire at age 55, Lexin's monthly pension would increase by \$537.45 to \$5,636.06; Vattimo's monthly pension would increase by \$703.70 to \$7,108.21; and Webster's monthly pension would increase by \$1,073.67 to \$10,862.41.

SUPERIOR COURT OF THE STATE OF CALIFORNIA FOR COUNTY OF SAN DIEGO CENTRAL DIVISION

Clerk of the Superior Court

MAY 1 7 2005

THE PEOPLE OF THE STATE OF CALIFORNIA

Plaintiff,

VS.

Flaillui.

Defendant.

RONALD LEE SAATHOFF,

DECLARATION IN SUPPORT OF Deputy

ARREST WARRANT

Case No.

CD190930-02

D.A. No.

ABM833-02

I, VINCENT GIAIME, declare:

I am a peace officer employed by the San Diego District Attorney's Office and I allege and state the following:

I have been employed as a District Attorney Investigator for approximately six years. I am currently assigned to the Special Operations Division. I have been a peace officer or special agent for over 31 years. Prior to working for the District Attorney's Office, I was employed by the Naval Criminal Investigative Service for twenty-two years. Prior to that, I vas employed by the New York State Special Prosecutor's Office as a special investigator investigating corruption in the criminal justice system for three years. During my career, I have investigated hundreds of political corruption and fraud cases.

During the course of my duties with the District Attorney's Office, I was assigned in June 2004 to investigate reported violations of Government Code 1090 Conflict of Interest contracts, sales and purchases by members of the San Diego City Employee Retirement System (SDCERS) Board of Trustees, and other City employees who may come within the purview of Government Code Section 1090. It was determined that six SDCERS Board trustees participated in and voted on the contribution agreement later identified as Manager's Proposal 2 (MP2), which was tied to the City approving certain City employees receiving enhanced retirement benefits. The six trustees include Cathy LEXIN, Ronald L. SAATHOFF, John A. TORRES, Teresa (Terri) A. WEBSTER, Sharon K. WILKINSON and Mary E. VATTIMO.

In conducting the investigation I have learned the following information based upon my discussions with witnesses, and by reviewing the following categories of documents: (1) depositions taken during the civil case entitled <u>Gleason v. San Diego Citv Employees Retirement System</u> (GIC 803779); (2) minutes and tape recordings of SDCERS Board meetings; (3) minutes of open and closed sessions of the San Diego City Council; (4) memorandums of understanding signed in 2002 between the City of San Diego and various local unions; (5) email communications of Larry Grissom (SDCERS retirement

dministrator); (6) emails of various City employees, Cathy LEXIN, Mary E. VATTIMO, eresa (Terri) WEBSTER, Ed Ryan, Patricia Frazier, Kelly Salt, Les Girard, Bruce Herring and others; (7) the Blue Ribbon Committee Report on City Finances; (8) City Attorney Interim Reports; (9) numerous City documents, including the "table books" utilized by City employees during the meet and confer process of 2002; (10) payroll records of City personnel, and (11) the report prepared by Vinson and Elkins LLP at the request of the City (authors Paul S. Maco and Richard C. Sauer).

During my investigation I determined that SDCERS is responsible for administering and managing the defined benefit retirement funds for the City of San Diego, the Unified Port District and the Airport Authority (the plan sponsors), and for their General members, Safety members, Elected Officers and Retirees. The San Diego City Council, as the Plan Sponsor, establishes benefits and makes contributions to support benefits; SDCERS invests the assets to reduce future City contributions, administers the benefits and provides the cost of these benefits. The SDCERS Board of Administration is compromised of 13 trustees, 3 representatives from the City (City Manager, City Auditor and City Treasurer, or designees); 4 citizens appointed by the City Council; 3 representatives elected by General Members; 2 representatives elected by police and fire safety members (one of each) 1 representative elected by the retired members.

Ronald L. SAATHOFF is a Fire Captain with the San Diego Fire Department and has been the President of the Firefighters International Association of Firefighters Local 145 since 1980. He has represented the Firefighter's on the SDCERS' Board since 1985 and was on the Board during the negotiation and vote of MP2.

Cathy LEXIN is the City of San Diego Human Resources Director and was appointed to represent the City Manager's Office on the SDCERS' Board in June 2001. She is also a General Member of SDCERS as a city employee.

Teresa (Terri) A. WEBSTER was the Assistant Auditor and Comptroller for the City of San Diego and was appointed to SDCERS' Board to represent the City Auditor and Comptroller. She has been on the SDCERS' Board since approximately October 1995.

Mary E. VATTIMO is the Treasurer of the City of San Diego and was appointed to SDCERS' Board when she became the City Treasurer in June 2001. She has been a City employee since 1987 and is a General Member of SDCERS.

Sharon K. WILKINSON has been a City employee since 1975 and is currently a Management Analyst for the City. She was elected to SDCERS' Board in 1992 by the General Members and has served three consecutive terms. She is a member of the Municipal Employees Association.

John A. TORRES is a latent fingerprint examiner for the San Diego Police Department Crime Laboratory and is a General Member of the SDCERS. He is a member

and the Vice President of the Municipal Employee Association and is serving his second term on the SDCERS' Board.

SDCERS was established by the City, essentially as a trust. It is administered by the Board and not the City or the City Council. The Board acts as a fiduciary as to the beneficiaries of SDCERS (its members) and its duties towards these beneficiaries in carrying out its administrative functions take precedence over any other duties that the Board may have to other entities involved in SDCERS, including the City. The City Charter directs the City Treasurer to hold SDCERS funds separate from the funds of the City and payments may only be made at the direction of the Board.

The California Constitution requires members of the Board to act as fiduciaries and to act solely in the interest of and for the exclusive purpose of protecting and preserving benefits of its members while minimizing employer contributions. The duty to its members takes precedence over all other duties. The constitution provides board members must act "with care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims."

A pension system derives its ability to pay benefits from three sources: employer contributions, employee contributions and earnings generated from such contributions. Under SDCERS, both the City and its members must contribute certain amounts as prescribed by the City Charter and applicable municipal statutes in order to fund the benefits. Employees make contribution rates as a percentage of compensation, and are based on the age of a member upon entry into SDCERS and actuarial calculations that are approved by the Board.

The City is to contribute annually an amount <u>certified by the actuary</u> that is determined to be the actuarially required contribution for the City. Each year the Board selects an actuary to perform an actuarial valuation of the plan to determine whether the plan currently has the funds necessary to satisfy it's current and future benefit obligations. The annual actuarial valuation of a defined benefit plan is based on various actuarial assumptions, such as investment performance, employee retention rates, mortality tables, expected increases in compensation and expected cost-of-living adjustments. This analysis permits the Board to determine the necessary contributions made by the City and its employees to satisfy the annual cost under the City's defined benefit plan with SDCERS and the overall funding status of the plan.

The SDCERS Board of Trustees voted to approve and accept the City of San Diego's proposal, (MP2), on July 11, 2002. The Board's approval of MP2, which deferred a percentage of City of San Diego employer contributions and avoided the City's obligation of having to make a balloon payment to SDCERS as negotiated under the terms of Manager's Proposal 1 (MP1), was tied to a negotiated enhanced retirement benefits agreement that had been negotiated during the 2002 "meet and confer" labor negotiations

atween the City of San Diego and three of the City of San Diego Employee bargaining unions. These unions included the San Diego Firefighter's Local 145, Municipal Employees Association and Local 127 American Federation of State County, and Municipal Employees. Cathy LEXIN, Teresa (Terri) A. WEBSTER, John A. TORRES, Ronald L. SAATHOFF, Sharon K. WILKINSON and Mary E. VATTIMO, all San Diego City employees and SDCERS Trustee Board members, personally benefited as a result of their involvement with MP2.

Government Code Section 1090 provides in part:

"Members of the Legislature, state, county, district, judicial district, and city officers or employees shall not be financially interested in any contract made by them in their official capacity, or by any body or board of which they are members. Nor shall state, county, district, judicial district, and city officers or employees be purchasers at any sale or vendors at any purchase made by them in their official capacity..."

By the fall of 2001, it was apparent that the investment markets were continuing to suffer a downturn in returns, which eroded the SDCERS earnings. In February 2002 a draft actuarial report for the fiscal year ended 06/30/01 became available from the SDCERS actuary Richard Roeder. The report showed the funded ratio had dropped to 89.9 % and appeared to be on a downward spiral. This caused significant concerns for the City of San Diego as demonstrated by a series of internal emails. The City had an obligation under the 1996 MP1 agreement to ensure the funding ratio would not go below 82.3%. If and when this occurred the City would be required to increase the percentage of the payments made to the SDCERS and to make a balloon payment which was estimated at the time to be between \$25 million to \$100 million, depending upon various interpretations of MP1. Deputy City Manager Bruce Herring was interviewed on April 12, 2005. He stated that the City was quite concerned about making the balloon payment, which would have had a significant negative impact on the City budget.

In the spring of 2002, the City engaged in the "meet and confer" process with the City employee unions. During that process a number of improved benefits were negotiated and offered to the unions. The benefits included salary increases and enhanced retirement benefits. The City's labor negotiators informed the unions in the meet and confer process that the enhanced retirement benefits were contingent upon the SDCERS Board approving a modification to the existing City contributions agreement (MP1). The modification to this agreement subsequently became known as MP2. The nexus between the enhanced retirement benefits and MP2 was confirmed during the March 24, 2005 interview of Daniel Kelley, former City of San Diego Labor Relations Manager, the April 1, 2005 interview of Michael McGhee, City of San Diego Labor Relations Manager, and the April 15, 2005 interview of current City Manager Lamont Ewell. This nexus is also documented in various City documents and the Memorandums of Understanding between the City and the three

aployee bargaining Unions, Firefighter's Local 145, MEA and Local 127 AFSCME that was ultimately approved by the San Diego City Council on November 18, 2002.

On May 29, 2002 according to SDCERS' Board minutes, City Manager Michael Uberuaga made a presentation to the SDCERS' Board, requesting the Board modify the existing contribution schedule under MP1, which was a binding agreement between the City and SDCERS.

MP1 had been approved by the SDCERS' Board in July 1996. It was also tied to enhanced retirement benefits and changed how the City funded SDCERS. MP1 permitted contribution to be made by the City to SDCERS at actuarial rates below the rates of more conventional funding methods.

In a memorandum dated June 10, 2002, from City Manager Uberuaga and directed to SDCERS, Uberuaga outlined MP2, which would reduce the funding ratio from 82.3% to 75% and establish other criteria that had the net effect of reducing the immediate need to pay substantial funds to SDCERS. It was referred to as a contribution rate stabilization plan, or, in other words, a method to eliminate the peaks and valleys in payments to SDCERS. Bruce Herring subsequently acknowledged to Vinson & Elkins that MP1's purpose was to push into the future current City costs of its retirement obligations. MP1 was drafted by Cathy LEXIN and she was also significantly involved in drafting MP2.

On June 12, 2002, fiduciary counsel for SDCERS, Robert Blum and Constance Hiatt, prepared a draft opinion letter which expressed serious reservations with MP2. The draft opinion noted that under its interpretation of MP1, prior to any modification, that if the funded ratio of 82.3% was reached it would require the City to pay at least \$75 million to SDCERS. The letter opined that there was a "material risk" if the City's modification of MP1 were to be litigated that the court would find that approval by the Board of the amendment was not a prudent exercise of their fiduciary duties.

In response to the fiduciary counsels' concerns, a further modification was made to the City's proposal, which addressed some of the issues raised in the draft letter. Uberuaga generated another memorandum, dated June 18, 2002, to reflect the changes to the proposal. The final version of this memorandum was sent via email from LEXIN to the secretary of the Board on June 19, 2002. The email chain indicates it was drafted at least in part by LEXIN.

On June 21, 2002, SDCERS held its monthly public meeting. The major topic was the City's proposal to modify its funding obligations to SDCERS. Individuals who attended the meeting included all 12 trustees (Vattimo was not present), Herring, Blum and Hiatt, and Richard Roeder. Herring presented MP2 to the Board, advising the Board that this proposal had substantial improvements over MP1. Prior to any discussion by the Board, or any remarks by fiduciary counsel or Roeder, LEXIN made a motion to adopt the proposal as presented by Herring. WEBSTER seconded the motion. This motion and its second were

ade prior to Blum and Roeder expressing their respective concerns. Blum's and Roeder's concerns about the proposal were known to both LEXIN and WEBSTER. However, before any vote was taken on the motion Blum and Roeder both made presentations to the Board, expressing several concerns regarding the City's proposal. Although Herring encouraged the Board to vote on the proposal at the meeting, the Board tabled the discussion until additional information could be obtained.

A memorandum dated July 8, 2002 was prepared by LEXIN and addressed to the Mayor and City Council in preparation of the Council's closed session hearing on July 9th. The memorandum advises the Mayor and Council that the initial reaction of the SDCERS' Board to the City's proposal to modify the funding arrangement was "quite negative" in light of the fiduciary counsels' position. The memorandum indicated that the City Manager's office wanted to be prepared to offer another modification, by eliminating the request to lower the funding ratio from 82.3% to 75% and adding a five year phase in if the 82.3% level is reached. The memorandum also stated "based upon our conversations with the Retirement Administrator [Lawrence B. Grissom], we anticipate a motion from a Board member which would further modify the proposal before the board..." On July 9th the City Council voted in closed session to approve the additional modification, if it was necessary to obtain approval. Present in the closed door session were, among others, LEXIN, Herring and City Auditor and Comptroller Edward Ryan. Ryan was the supervisor of VATTIMO during this time period.

On April 21, 2005, and May 4, 2005, Lawrence Grissom was interviewed and confirmed that he was aware of the added change to the proposal and identified Ronald SAATHOFF as the Board member referenced in the LEXIN memorandum of July 9, 2002.

On July 11, 2002, a special public meeting of the SDCERS Board was held to address the City's proposal regarding the modification to the City's contribution to SDCERS. All 13 trustees were present, as were Blum, Hiatt, Roeder, Herring, and others. Herring made a presentation in support of MP2 and also encouraged the Board to act immediately on the matter. Roeder and Blum also addressed the Board. During public comment various labor union representatives spoke in favor of the City's proposal. One former Board trustee spoke in opposition and asked the rhetorical question "Would you as a Board vote for this or would the City Manager even be here if there wasn't this guid pro quo going on where there was an increase of benefits tied to this proposal? LEXIN thereafter made a motion to support the City Manager's request to adopt MP2, it was seconded by WEBSTER. After lengthy discussion SAATHOFF offered a substitute motion, consistent with the motion described in the LEXIN memorandum of July 9, which kept the funding ratio at 82.3% along with the other changes. This is the substitute motion which LEXIN was already aware of, and had briefed the City Council regarding two days earlier. It was to be made if her initial motion appeared to be unsuccessful. The Board ultimately passed the substitute motion 8-2, with one abstention. Two appointed Board members Richard Vortmann and Diann Shipione left prior to the vote due to expressed time

nstraints. The two individuals who opposed the motion were Thomas Rhodes, Police Officers Association representative and David Crow, retiree elected official.

The six trustees, who benefited from the enhanced retirement benefits all voted in favor of the motion.

Ronaid L. SAATHOFF benefited as one of the enhanced retirement benefits of the 2002 "meet and confer" was to allow SAATHOFF to receive an increase in his retirement allowing him to add his union salary as the President of Firefighter's Local 145 to his Fire Department Captain's salary (which was collectively capped at the City's Labor Relations Manager salary) for use in his retirement benefit calculations. SAATHOFF subsequently retired and entered the Deferred Retirement Option Plan (DROP) on 7/02/2003 at age 55.356. His monthly pension benefit without the 2002 increase would have been \$7,173.43. As a result of his actions and the passage of MP2 he is receiving \$9,703.66 monthly.

John A. TORRES benefited as a general member of SDCERS. He received the general member retirement factor increase from 2.25% to 2.5% at age 55. TORRES subsequently retired on 1/22/2005 at age 55.869 and entered the DROP program. His monthly pension benefit without the 2002 increase would have been \$3,630.29. As a result of his actions and the passage of MP2 he is receiving \$4,016.81 as a monthly pension benefit.

Sharon K. WILKINSON benefited as a general member of SDCERS. She received the general member retirement factor increase from 2.25% to 2.5% at age 55. WILKINSON subsequently retired on 2/20/2005 at age 55 and entered the DROP program. Her monthly pension benefit without the 2002 increase would have been \$4,618.66. As a result of her actions and the passage of MP2 she is receiving \$5,096.26 as a monthly pension benefit.

Cathy LEXIN benefited as a general member of SDCERS. She received the general member retirement factor increase from 2.25% to 2.5% at age 55. LEXIN has not attained 55 years of age. However, at age 55 she will eligible to retire and receive \$5,636.06 monthly under the 2002 increase. Had she retired without the enhanced retirement benefits derived from MP2, her monthly pension benefit would have been \$5,098.61. These calculations are based upon the assumption her highest one year salary was \$128,518, which was her salary as of 07/19/2002. Subsequent salary increases since July 2002 act to increase the differential further.

Mary E. VATTIMO benefited as a general member of SDCERS. She received the general member retirement factor increase from 2.25% to 2.5% at age 55. VATTIMO has not attained 55 years of age. However, at age 55 she will be eligible to retire and receive \$7,108.21 monthly under the 2002 increase. Had she retired without the enhanced retirement benefits derived from MP2, her monthly pension benefit would have been

404.51. These calculations are based upon the assumption her highest one year salary was \$120,426, which was her salary as of 7/19/2002. Subsequent salary increases since July 2002 act to increase the differential further.

Teresa (Terri) A. WEBSTER benefited as a general member of SDCERS. She received the general member retirement factor increase from 2.25% to 2.5% at age 55. In addition, she is able to exceed the 90% salary cap because she was hired before she was 24 years of age. This option to exceed the salary cap was "grand parented" in the 2002 enhanced retirement benefits. WEBSTER has not attained 55 years of age. However, at age 55 she will be eligible to receive \$10,862.41 monthly under the 2002 increase. Had she retired without the enhanced retirement benefits derived from MP2, her monthly pension benefit would have been \$9,788.74. These calculations are based upon the assumption her highest one year salary was \$136,296, which was her salary as of 7/19/2002. Subsequent salary increases since July 2002 act to increase the differential further.

A chart summarizing the above-referenced calculations follows:

NAME	RETIREMENT DATE/AGE	MONTHLY PENSION BENEFIT W/O 2002 INCREASE	MONTHLY PENSION BENEFIT W/ 2002 INCREASE
CAATHOER	Retired 07-02-03 at age 55.356	\$7,173.43	\$9,703.66
SAATHOFF	Retired 01-22-05 at age 55.869	\$3,630.29	\$4,016.81
TORRES		\$4,618.66	\$5,096.26
WILKINSON	Retired 02-20-05 at age 55	\$4,010.00	

NAME	ANNUAL SALARY AS OF 07-19-02	MONTHLY PENSION BENEFIT W/O 2002 INCREASE (Assumes retirement at age 55)	MONTHLY PENSION BENEFIT W/ 2002 INCREASE (Assumes retirement at age 55)
	\$128,518	\$5,098.61	\$5,636.06
LEXIN		\$6,404.51	\$7,108.21
OMITTAV	\$120,426		\$10,862.41
WEBSTER	\$136,296	\$9,788.74	\$10,002.41

On February 18, 2004, a class action suit entitled Gleason, et al v San Diego City Employees Retirement System (SDCERS), case number GIC 803779, was filed in Superior Court of the State of California for the County of San Diego. The plaintiff, James F.

rason, a member of the SDCERS, contended that a 2002 contract referred to as MP2 entered into between the City of San Diego and the Board of Administration of SDCERS, should be voided because six of the 13 trustees on the Board had a financial interest in should be voided because six of the 13 trustees on the Board had a financial interest in that contract. He alleged that six trustees' action violated Government Code section 87100, a statue contained in the Political Reform of 1974, and Government Code section 1090. SDCERS and the City of San Diego litigated the matter for over a year, then, in August 2004, entered into a settlement with the plaintiff class on terms that bolstered the financial stability of the retirement systems. The settlement essentially obviated any future operation of MP2.

The discovery process included the taking of several depositions. SAATHOFF was deposed on January 23, 2004, TORRES was deposed on January 27, 2004, WEBSTER was deposed on January 29, 2004, LEXIN was deposed on January 30, 2004, WILKINSON was deposed on February 5, 2004 and VATTIMO was deposed on February 9, 2004.

TORRES and WILKINSON in their respective depositions acknowledged that the enhanced retirement benefits were contingent upon the SDCERS Board approval of MP2.

Diann Shipione, a SDCERS Board trustee, was interviewed on March 30, 2005. She said it was quite evident to her that the enhanced retirement benefits were contingent ipon the SDCERS' Board approval of the modification of the City's contribution to the retirement system. She specifically recalled Uberuaga addressing the Board and explaining that these retirement enhancements were conditioned upon the Board approving the under funding. She said there was never any attempt to disconnect the two and it was apparent to her that the Board members that were affected by these benefits wanted them to be granted. She said it made absolutely no sense to under fund the retirement system. She further reported that she attempted to have MP2 nullified, but was unsuccessful. She said she recalled a number of the Board members telling her that they did not want to nullify the proposal but she specifically recalled Sharon, WILKINSON telling her that she (WILKINSON) did not want to give up her benefits.

The above information is made in support for the arrest of for Conflict of Interest in violation of Government Code 1090.

The description of is as follows:



This declaration has been reviewed by Deputy District Attorney Stephen R. Robinson.

I declare under penalty of perjury that the foregoing is true and correct.

Executed in San Diego County, California, on the 17th day of May, 2005.

Vinice I Securit

Declarant

Declaration read: 5/n/05 - HOLD TO 5/18/05 AT 2:00 PM Warrant to issue: 1550 5/17/05 - HOLD TO 5/18/05 AT 2:00 PM

The defendant is to be admitted to bail in the sum of \$5,000.

Judge of the Superior Court

IN THE SUPERIOR COURT OF THE STATE OF CALIFORNIA FOR THE COUNTY OF SAN DIEGO

THE PEOPLE OF THE STATE OF CALIFORNIA, -

Plaintiff,

v.

ATHY LEXIN, dob 12/21/50;

ONALD LEE SAATHOFF, dob 02/21/48;

OHN ANTHONY TORRES, dob 03/11/49;

1ARY ELIZABETH VATTIMO, dob 08/09/60;

ERESA AJA WEBSTER, dob 04/22/62;

HARON KAY WILKINSON, dob 02/20/50;

Defendants

CT No. SCD190930 DA No. ABM833

INFORMATION

PC296 DNA TEST STATUS SUMMARY

EXIN, CATHY AATHOFF, RONALD LEE ORRES, JOHN ANTHONY ATTIMO, MARY ELIZABETH DNA sample required upon conviction DNA sample required upon conviction

CHARGE SUMMARY

Count	Charge	Issue Type	Sentence Range	Special Allegations	Allegation Effect
1	GC1090	Felony	16-2-3/\$1,000		
	LEXIN, CATHY				
	SAATHOFF, RONALI	LEE			
	TORRES, JOHN ANTI	HONY			
	VATTIMO, MARY EL	IZABETH			
	WEBSTER, TERESA A	JА			
	WILKINSON SHARO	NKAY			

The District Attorney of the County of San Diego, State of California, accuses the Defendant(s) of committing, in the County of San Diego, State of California, the following crime(s):

CHARGES

COUNT 1 - CONFLICT OF INTEREST - SPECIFIED OFFICIALS

On or about and between May 29, 2002 and November 15, 2002, CATHY LEXIN, RONALD LEE SAATHOFF, JOHN ANTHONY TORRES, MARY ELIZABETH VATTIMO, TERESA AJA WEBSTER, and SHARON KAY WILKINSON, being a city officer and employee, and thus an officer and person prohibited by the laws of this state (Government Code Section 1090) from being financially interested in contracts made by him in his official capacity, and by a body or board of which he was a member; and from being a purchaser at any sale made by him in his official capacity; and from being a vendor at any purchase made by him in his official capacity, did willfully and unlawfully violate the provisions of such laws, by participating in the deliberative process and/or creation of Manager's Proposal 2, in violation of GOVERNMENT CODE SECTION 1090.

Pursuant to PENAL CODE SECTION 1054.5(b), the People are hereby informally requesting that defendant's counsel provide discovery to the People as required by PENAL CODE SECTION 1054.3.

The People reserve the right to amend the accusatory pleading to further allege any and all facts in aggravation in light of 3lakely v. Washington (6/24/2004) ____ U.S. ___ [124 S.Ct. 2531, 2004 WL 1402697].

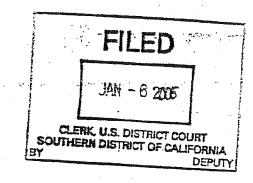
Sheriff's records indicate that as of the booking date one or more defendants have not yet provided a DNA sample to the DOJ database. Pursuant to Penal Code Section 296(e), the court shall order collection of DNA from the defendant(s) if idvised by the prosecuting attorney that a sample is required but has not been provided by the defendant. Pursuant to Penal Code sections 296/296.1, if not already required from a past conviction, any defendants who have not done so will be required to provide a sample upon conviction of this felony offense.

THIS INFORMATION, NUMBERED SCD190930, CONSISTS OF 1 COUNT.

Date

BONNIE M. DUMANIS
District Attorney
County of San Diego
State of California
by:

Deputy District Attorney



UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

January 2004 Grand Jury

UNITED STATES OF AMERICA,

Plaintiff,

12 v. 13

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27 28 RONALD SAATHOFF (1), CATHY LEXIN (2), TERESA WEBSTER (3) LAWRENCE GRISSOM (4), LORAINE CHAPIN (5),

Defendants.

Criminal Case No. 06C20043-BEN

INDICIMENI

Title 18, U.S.C., Sec. 371 -Conspiracy to Commit Wire and Mail Fraud; Title 18, U.S.C., Secs. 1343 and 1346 - Wire Fraud; Title 18, U.S.C., Secs. 1341 and 1346 - Mail Fraud; Title 18, U.S.C., Sec. 2 -Aiding and Abetting

The grand jury charges:

INTRODUCTORY ALLEGATIONS

At all times relevant to this Indictment:

The San Diego City Employees' Retirement System

The San Diego City Employees' Retirement System (hereinafter "SDCERS") administered the funds used to provide retirement, health insurance, disability and death benefits to current, former, and retired city employees and their beneficiaries. The City of San Diego (hereinafter "the City") was SDCERS' plan sponsor. As the plan sponsor, the City was responsible for providing SDCERS with sufficient

JBO:nlv(2):San Diego

1/6/06

EXHIBIT 78 WIT. McHamas 5906 DATE Kramm&Associates, Inc

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- 2. With the assistance of an outside actuary, SDCERS determined how much the City needed to pay each year to ensure that SDCERS had sufficient funds to pay for the retirement, health insurance, disability, and death benefits of the City's current, former, and retired employees. The outside actuary also calculated SDCERS' funding ratio on an annual basis. SDCERS' funding ratio was the ratio between its assets and liabilities. A funding ratio of less than 100% meant that SDCERS did not have sufficient assets to cover its liabilities.
- 3. Until its reorganization in April 2005, a Board of Administration (hereinafter "SDCERS Board") with 13 trustees governed the administration of SDCERS' funds. The SDCERS Board included four trustees appointed by the City Council, three city officials serving as ex-officio trustees, one trustee elected by city firefighters, one trustee elected by city police officers, three trustees elected by city general employees, and one trustee elected by retired city employees. The SDCERS Board had to approve by majority vote any city proposal that would change the City's contribution requirements to SDCERS.
- 4. Each trustee of the SDCERS Board had a fiduciary duty to the Board and public. The primary fiduciary duty of the SDCERS Board was to ensure that SDCERS had sufficient funds to pay for the retirement, health insurance, disability, and death benefits of the City's current, former, and retired employees. This fiduciary duty required each SDCERS Board Trustee to disclose all material information to

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- Consistent with this fiduciary duty, the SDCERS Board enacted its "Rules of the Retirement Board of Administration." According to these Rules, each SDCERS Board Trustee had a fiduciary duty to "avoid any activity which may be interpreted as a conflict of interest, * to "conduct all SDCERS business responsibilities in a fair manner and be honest in all business negotiations, and "communicate to an appropriate Board or staff member information on actions that may be violations of the law, [the Rules of the Retirement Board of Administration], or actions which may be conflicts of interest." The Rules of the Retirement Board of Administration also prohibited each SDCERS Board Trustee from "directly or indirectly seek[ing] or accept[ing] gifts, money or property that would influence or appear to influence the conduct of his or her duties" and from "knowingly engag[ing] in any serial, rotating, or seriatim meeting through which a quorum of the Board becomes involved in the acquisition of information or deliberation of any issue, unless the notice and public access provisions of the open meeting laws are satisfied."
- Defendant RONALD SAATHOFF (hereinafter "defendant SAATHOFF") was an SDCERS Board Trustee from the 1980s until 2005 as the firefighters' representative, and was subject to the fiduciary duties described above. Defendant SAATHOFF also was president of Local 145, the firefighters' labor union, and was the lead negotiator for Local 145 during the 2002 labor negotiations with the City.

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- Defendant TERESA WEBSTER (hereinafter "defendant WEBSTER") was an ex-officio SDCERS Board Trustee from 1995 until 2005, and was subject to the fiduciary duties described above. Defendant WEBSTER also was the City's Assistant Auditor and Comptroller, and later became the City's acting Auditor and Comptroller.
- The Administration Division of SDCERS managed the daily affairs of SDCERS and directly interacted with the SDCERS Board. Defendant LAWRENCE GRISSOM (hereinafter "defendant GRISSOM") was the Administrator of SDCERS and in charge of its Administration Division 16 from 1987 until 2005. According to the Rules of the Retirement Board 17 of Administration, defendant GRISSOM was to "be solely responsible to 18 the Board." As the Administrator of SDCERS, defendant GRISSOM had the duty to keep the SDCERS Board fully informed of all material information, including information about proposals that could affect the funding of SDCERS and information about whether an SDCERS Board decision could impact the financial interests of an SDCERS Board Trustee.
- The Legal Services Division of SDCERS had the duty to provide legal advice and assistance to the SDCERS Board. Defendant LORAINE CHAPIN (hereinafter "defendant CHAPIN") was the General Counsel of SDCERS and in charge of its Legal Services Division from 28 1997 until 2006. As the General Counsel of SDCERS, defendant CHAPIN

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had the duty to keep the SDCERS Board fully informed of all material information, including information about (a) proposals that could affect the funding of SDCERS, (b) SDCERS Board decisions that could impact the financial interests of an SDCERS Board Trustee, (c) whether SDCERS Board Trustees and staff were complying with state and federal laws, and (d) whether an SDCERS Board Trustee had a conflict of interest.

Manager's Proposals 1 and 2, and the 2002 Labor Negotiations

11. In 1996, the City and the SDCERS Board entered into an agreement called "Manager's Proposal 1" (hereinafter "MP1"). Under MP1, the SDCERS Board agreed to permit the City to pay less than the actuarially recommended amount of money necessary to ensure a funding ratio of 100%. If the funding ratio fell below 82.3%, then a "trigger" would be hit, and the City would be required to pay to SDCERS an imminent multi-million dollar balloon payment. Under one interpretation of MP1, the City would have been required to restore the funding ratio to 82.3%, requiring the City to pay approximately \$25 million for each percentage point that the funding ratio fell below 82.3%. If the funding ratio fell below 78%, the City would have faced a balloon payment of more than \$100 million.

12. In 2002, the City was scheduled to negotiate city employee benefits with four labor unions: Local 145 (the firefighters' union), the Police Officers' Association, Local 127 (blue collar city employees), and the Municipal Employees Association (white collar city employees). The blue collar city employees and white collar city employees were commonly called the "general members." These labor negotiations were commonly called "meet and confer." The four labor unions wanted increased retirement benefits. The general members'

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1 labor negotiators wanted the City to increase the general members' 2 retirement multiplier from 2.25% to 2.5%. This increase from 2.25% to 2.5% would have raised the yearly retirement for defendants LEXIN, WEBSTER, GRISSOM, and CHAPIN by thousands of dollars each year.

13. An issue in the Local 145 negotiations was whether the firefighters would receive certain benefits, including whether defendant SAATHOFF would receive the "presidential leave retirement benefit." The presidential leave retirement benefit would permit defendant SAATHOFF to base his retirement calculation on the combination of his fire captain salary and his union president salary. Without the presidential leave retirement benefit, defendant SAATHOFF's retirement benefit would have been based solely on his fire captain's salary. With the presidential leave retirement benefit, defendant SAATHOFF's retirement would have increased by more than \$25,000 per year.

14. In 2002, the City and some of the labor unions reached tentative labor agreements to grant numerous retirement benefit increases to some of the labor unions, including increasing the general members' retirement benefit multiplier from 2.25% to 2.5% and giving defendant SAATHOFF the presidential leave retirement benefit. If enacted, these increased benefits would have raised the retirement benefits for defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN. The tentative increased retirement benefits were made "contingent" on the SDCERS Board agreeing to modify MP1 so the City would avoid making the imminent required multi-million dollar balloon payment if SDCERS' funding ratio fell below 82.3%. If the SDCERS Board did not agree to modify MP1, then the City would not be required to implement the increased retirement benefits, including the 2.25% to 2.5% increase

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1 and the presidential leave retirement benefit. If MP1 had remained unchanged, defendant SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN would have lost thousands of dollars each year in increased retirement benefits. The proposal to modify MP1 and to make increased retirement benefits contingent upon that modification became known as "Manager's Proposal 2" (hereinafter "MP2").

- 15. In 2002, the City presented the SDCERS Board with multiple versions of MP2, each of which would have modified MP1's trigger so the City would only have paid the "full actuarial rate" (estimated at a total of between \$25 and \$40 million) phased in over a series of years if the funding ratio fell below the trigger, rather than the imminent multi-million dollar balloon payment that could have exceeded \$100 million if MP1 remained unmodified. In these versions of MP2, the City also proposed lowering the MP1 trigger from 82.3% to .75%.
- 16. On or about Friday, June 21, 2002, the SDCERS Board met and reviewed a version of MP2. Defendant GRISSOM told the SDCERS Board that the recently negotiated retirement benefits were contingent upon the SDCERS Board agreeing to adopt MP2. At this meeting, the City Manager's Office proposed reducing the MP1 trigger from 82.3% to 75%. At this meeting, defendant SAATHOFF reviewed the text of MP1 and stated that MP1 "could be very easily interpreted" to require the City to pay SDCERS the funds necessary to restore SDCERS' funding ratio to 82.3% if the funding ratio fell below 82.3%. interpretation of MP1, the City would be required to make an imminent balloon payment, possibly exceeding \$100 million, if the trigger were hit. After extensive discussion, the SDCERS Board did not reach a decision on the City's proposal, and agreed to revisit the issue in July 2002.

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with defendant GRISSOM for several hours and discussed the status of his presidential leave retirement benefit. After the meeting, defendant GRISSOM sent an e-mail to defendant LEXIN, and asked about the status of the presidential leave retirement benefit. In response, defendant LEXIN sent an e-mail to defendant GRISSOM: "we agreed to 'presidential leave' subject to attorneys working out the bugs, Ron knows (as recently as discussions today) that the attorneys and auditors are working with Dan on language . . . not yet in place . . . TELL RON TO COOL HIS JETS."

memorandum for the SDCERS Board about MP2 which she shared with defendants WEBSTER and GRISSOM, and others. The memorandum, written in the name of a Deputy City Manager, stated that the recently negotiated retirement benefits were "contingent" upon the SDCERS Board's modification of MP1 and its trigger. After receiving edits

18. On or about July 1, 2002, defendant LEXIN drafted a

and suggestions from defendants WEBSTER and GRISSOM, and others, defendant LEXIN caused the memorandum to be sent by e-mail to the

SDCERS Board on or about July 8, 2002.

19. On or about July 9, 2002, defendant LEXIN briefed the City Council in a closed session meeting. Defendant LEXIN informed the City Council that the SDCERS Board might not adopt MP2 with a 75% trigger. She also informed the City Council that, according to defendant GRISSOM, an SDCERS Board Trustee would be making a motion on July 11, 2002, to maintain the trigger at 82.3%, but "phase-in" the "full actuarial rates" over a series of years. Under the 82.3% "phase-in" proposal, "the practical impact on the City would be no different than the previously authorized" 75% MP2 proposal. Based on

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defendant LEXIN's recommendation, the City Council agreed to accept the 82.3% "phase-in" MP2 proposal, but only as a "backup" if the 3 SDCERS Board refused to adopt the 75% MP2.

20. On or about July 11, 2002, the SDCERS Board met again to consider MP2. Defendant GRISSOM reminded the SDCERS Board that the recently negotiated benefit enhancements were contingent on the SDCERS Board agreeing to modify MP1. At the meeting, the City Manager's Office continued to propose a version of MP2 which would reduce the trigger from 82.3% to 75%. After extensive discussion about the 75% MP2 proposal, defendant SAATHOFF made a motion to "amend" the City's MP2 proposal (hereinafter "SAATHOFF's MP2 proposal"). Under defendant SAATHOFF's MP2 proposal, the 82.3% trigger would remain in place. However, if the funding ratio fell below 82.3%, the City's balloon payment would be phased in over a series of years, and would be limited to the "full actuarial rate," which was far less than the over \$100 million payment that could have been required if MP1 remained unchanged. Defendant SAATHOFF's motion to amend MP2 was the motion that defendant LEXIN had described during the July 9, 2002 City Council closed session meeting. After limited discussion, the SDCERS Board voted 8-2, with one abstention and two members absent, to approve defendant SAATHOFF's MP2 proposal, subject to further review by SDCERS' outside fiduciary counsel and actuary.

21. Shortly after the July 11, 2002 vote, defendants LEXIN, WEBSTER, GRISSOM, and CHAPIN, and others, took the steps to create the legislation and other documents necessary to implement defendant SAATHOFF'S MP2 proposal and the contingent retirement benefits negotiated in 2002, including defendant SAATHOFF's presidential leave retirement benefit, which later became Resolution 297212.

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- 22. On or about October 21, 2002, the City Council adopted 2 Resolution 297212 on its consent agenda without public comment. 3 Resolution 297212 gave defendant SAATHOFF the presidential leave retirement benefit.
 - 23. On or about November 15, 2002, the SDCERS Board formally approved defendant SAATHOFF's MP2 proposal by a 10-2 vote. During the meeting, defendant SAATHOFF stated that his July 11, 2002 MP2 proposal was an "off-the-seat-of-the-pants" motion.
- 24. On or about November 18, 2002, the City Council heard public comment in favor of and against the ordinances necessary to put into effect defendant SAATHOFF's MP2 proposal, as well as the increased retirement benefits that were contingent on the SDCERS Board adopting MF2. After hearing the arguments of defendants SAATHOFF and LEXIN, 14 and others, the City Council approved the ordinances necessary to implement the retirement benefits contingent on defendant SAATHOFF's 16 MP2 proposal.

Count 1

18 U.S.C. § 371

The Conspiracy

- 25. The allegations set forth in paragraphs 1 through 24 above are realleged as if fully set forth herein.
- 26. Beginning in or before January 2001, and continuing up to and including January 6, 2006, within the Southern District of California, and elsewhere, defendants SAATHOFP, LEXIN, WEBSTER, GRISSOM, and CHAPIN did knowingly conspire with each other and others known and unknown to the grand jury to commit offenses against the United States, that is, honest services mail and wire fraud, by conspiring and agreeing to devise a material scheme and artifice to

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1 defraud and to deprive the SDCERS Board Trustees, members of SDCERS, and the citizens of the City of San Diego of their intangible right 10

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of honest services of their public officials to be performed free from corruption, fraud, undue influence, conflict of interest, and deceit, and, in executing said scheme, deposited and caused to be deposited matters and things to be sent and delivered by private and commercial interstate carriers, and caused matters and things to be delivered by the United States Postal Service and private and commercial interstate carriers according to the direction thereon, and caused writings, signs, signals, and sounds to be transmitted by means of wire in interstate commerce; in violation of Title 18, United States Code, Sections 1341, 1343, and 1346.

Manners And Means

- 27. In furtherance of this conspiracy, and to effect the objects thereof, the defendants utilized the following manners and means, among others: .
- Defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN, and others, fraudulently devised a plan to modify MP1 and its trigger in sufficient time so the City would avoid making the imminent multi-million dollar balloon payment to SDCERS that MP1 required.
- b. Defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN, and others, fraudulently agreed to obtain the presidential leave retirement benefit for defendant SAATHOFF in exchange for his support of a proposal to modify MP1 so the City would avoid the imminent multi-million dollar balloon payment that it owed SDCERS under MP1.
- Defendants SAATHOFF, LEXIN, and WEBSTER, and others, negotiated and agreed to accept increased retirement benefits,

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including defendant SAATHOFF's requested presidential leave retirement benefit and the increase in the retirement multiplier from 2.25% to 2.5% for general members, in exchange for their support of a proposal to modify MP1 so the City would avoid the multi-million dollar balloon payment that it owed SDCERS under MP1.

- Defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN, and others, fraudulently concealed material information about the increased retirement benefits, including defendant SAATHOFF's presidential leave retirement benefit, from SDCERS Board Trustees, so that the other SDCERS Board Trustees would vote to approve the modification of MP1, which would allow the City to avoid the imminent multi-million dollar balloon payment that it owed SDCERS, would allow the defendants and others to receive increased retirement benefits, including defendant SAATHOFF's presidential leave retirement benefit, and would allow defendants LEXIN, WEBSTER, GRISSOM, and CHAPIN to maintain their positions with the City and SDCERS.
- Defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, CHAPIN, and others, fraudulently concealed material information concerning MP2 and other proposals from SDCERS Board Trustees, so that the other SDCERS Board Trustees would vote to approve the modification of MP1, which would allow the City to avoid the imminent multi-million dollar balloon payment that it owed SDCERS, would allow the defendants and others to receive increased retirement benefits, including defendant SAATHOFF's presidential leave retirement benefit, and would allow defendants LEXIN, WEBSTER, GRISSOM, and CHAPIN to maintain their positions with the City and SDCERS.
- Defendants SAATHOFF, LEXIN, and GRISSOM, and others, fraudulently concealed from the SDCERS Board a prearranged plan for

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I defendant SAATHOFF to submit his MP2 proposal, which, if approved, guaranteed defendant SAATHOFF his presidential leave retirement benefit.

Defendants SAATHOFF, LEXIN, and WEBSTER, and others, g. fraudulently voted in favor of defendant SAATHOFF's MP2 proposal, and by concealing material information from the other SDCERS Board Trustees, defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN deceived and fraudulently induced the other SDCERS Board Trustees to vote in favor of defendant SAATHOFF's MP2 proposal, which would allow the City to avoid the imminent multi-million dollar balloon payment that it owed SDCERS, would allow the defendants and others to receive increased retirement benefits, including defendant SAATHOFF's presidential leave retirement benefit; and would allow defendants LEXIN, WEESTER, GRISSOM, and CHAPIN to maintain their positions with the City and SDCERS.

h Defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN, and others, drafted and assisted in the drafting of legislation implementing defendant SAATHOFF's MP2 proposal and the contingent retirement benefits negotiated in 2002, knowing that defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN, and others had concealed material information from the SDCERS Board Trustees, including the nature and existence of the presidential leave retirement benefit.

Defendants SAATHOFF, GRISSOM, and CHAPIN, and others, fraudulently concealed from SDCERS Board Trustees material information concerning defendant SAATHOFF's purchase of service credits that enhanced defendant SAATHOFF's retirement benefits.

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By deceiving the SDCERS Board Trustees and fraudulently concealing material information from SDCERS Board Trustees, defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN caused significant harm to the financial integrity of SDCERS.

OVERT ACTS

- In furtherance of said conspiracy and to effect and accomplish the objects thereof, the following overt acts, among others, were committed within the Southern District of California, and elsewhere:
 - On or about January 8, 2001, defendant SAATHOFF sent a letter to a city employee requesting that he receive the presidential leave retirement benefit "consistent with the current procedure followed by the P.O.A. and the M.E.A."
 - On or about September 18, 2001, defendant SAATHOFF told a city employee that, as part of the presidential leave retirement benefit, he wished to combine his city salary with his union president salary to increase his high one year retirement calculation from \$80,881.16 to \$114,964.66.
 - On or about October 11, 2001, defendant WEBSTER sent an e-mail to defendant LEXIN entitled "EEEK," expressing defendant WEBSTER's concerns about SDCERS' funding ratio and decreasing earnings.
 - On or about November 5, 2001, defendant WEBSTER sent d. an e-mail to a city labor negotiator discussing "Ron's Plan B" and that city labor negotiators should "keep the bargaining chip in your pocket."

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⊋.	On or about November 13, 2001, defendant LEXIN wrote
	a memorandum recommending that the presidential leave
	retirement benefit be discussed in the context of the
	2002 labor negotiations with Local 145 and the other
	labor unions

- f. On or about January 3, 2002, defendant WEBSTER sent an e-mail to defendant LEXIN, and others, stating that the SDCERS fund earnings from November 2000 until November 2001 had decreased by 85%, and that "these are SERIOUS consequences and needs attention."
- g. On or about February 27, 2002, defendant WEBSTER wrote an e-mail to defendant LEXIN, and others, stating: "OH BOY . . . the CERS earnings for Jan is negative (\$1.7) . . . we're moving in the wrong direction!"
- h. On or about February 28, 2002, defendants LEXIN and WEBSTER, and others, discussed via e-mail a plan "to use Ron Saathoff to get" the SDCERS Board's "attention."
- i. On or about March 7, 2002, defendant GRISSOM sent an e-mail to defendant WEBSTER stating that a reporter had inquired about the City underfunding SDCERS, and asked defendant WEBSTER "is there any 'party line' for me to communicate?"
- j. On or about March 13, 2002, defendant WEBSTER sent an e-mail to defendants LEXIN and GRISSOM, and others, about the SDCERS funding ratio, and stated that: "This is a big and serious problem. . . . especially since the \$20m+ trigger is getting closer."

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k.	On or about April 15, 2002, defendant GRISSOM sent an
n kizh en his	e-mail to defendant WEBSTER estimating that the
	funding ratio would fall below the 82.3% MP1 trigger,
*	and asked defendant WEBSTER to "[p]lease treat this as
	confidential for the moment haven't shared
	with any of the other Board members - yet."

- On or about April 17, 2002, defendant WEBSTER sent an e-mail to defendant LEXIN, and others, stating that if modifying the MP1 trigger were "tied to benefit increases I think it would pass."
- m. On or about May 21, 2002, defendant WEBSTER sent an email to a city employee stating: "The Local 145 write up you sent out did not state that their increased offset was contingent on the Board laxing the trigger.

 . . . I thought ALL retirement improvements (including the preside[n]tial leave(?)) were contingent on the trigger. . . especially need Ron behind releasing the trigger since he runs the show at
- n. On or about June 14, 2002, defendant LEXIN wrote a memorandum stating that the retirement benefits negotiated during the 2002 labor negotiations were contingent upon the SDCERS Board approving a modification of MP1.
- On or about June 21, 2002, defendant SAATHOFF told the SDCERS Board that MP1 "could be very easily interpreted" to require the City to pay SDCERS the

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funds necessary to restore SDCERS' funding ratio to 82.3% if funding ratio fell below 82.3%.

- On or about June 25, 2002, defendant LEXIN sent an ep. mail to an SDCERS Board Trustee who did not attend the June 21, 2002 SDCERS Board meeting, stating that defendant LEXIN and others "REALLY do need you!" at the July 11, 2002 SDCERS Board meeting to vote on MP2.
- On or about July 1, 2002, defendant LEXIN sent via email a draft memorandum to defendant GRISSOM, which contained proposed answers to the questions of an SDCERS Board Trustee about MP2.
- On or about July 2, 2002, defendant WEBSTER reviewed defendant LEXIN's July 1, 2002 draft memorandum, and sent an e-mail stating: "FYI Regarding cathy's letter my biggest suggestion to her is to eliminate any reference to fitch and rating agencies in #6. letter will be seen by press and the city does not need to telegraph its pension problems to the rating agencies who don't research the topic to any great level now. '
- On or about July 8, 2002, defendant LEXIN wrote a 5. memorandum urging the City Council to preapprove a motion to amend MP2 that an SDCERS Board Trustee would be making on July 11, 2002.
- On or about July 11, 2002, defendant SAATHOFF made a t. motion before the SDCERS Board to amend the City's version of MP2.

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On or about July 11, 2002, defendants SAATHOFF, LEXIN,
and WEBSTER, and others, voted in favor of defendant
SAATHOFF's MP2 proposal, and defendants SAATHOFF,
LEXIN, WEBSTER, GRISSOM, and CHAPIN did not disclose
defendant SAATHOFF's presidential leave retirement
benefit to the other SDCERS Board Trustees.

- v. On or about July 18, 2002, defendants CHAPIN and GRISSOM, and others, met to discuss how to implement benefits conveyed under MP2, including the presidential leave retirement benefit.
- w. On or about August 26, 2002, defendants LEXIN, CHAPIN, and GRISSOM, and others, met to discuss how to implement benefits conveyed under MP2, including the presidential leave retirement benefit.
- x. On or about September 6, 2002, defendant CHAPIN sent an e-mail to defendants LEXIN, WEBSTER, and GRISSOM, and others, stating: "The Board has not reviewed the Presidential Leave issue and does not have to."
- y. On or about November 5, 2002, defendant WEBSTER sent an e-mail to defendant LEXIN suggesting that they try to convince the SDCERS Board to reduce the MP1 82.3% trigger "BEFORE the actuary report comes out with the ratio news."
- Z. On or about November 15, 2002, defendants SAATHOFF and WEBSTER, and others, voted in favor of defendant SAATHOFF's MP2 proposal, and defendants SAATHOFF, WEBSTER, GRISSOM, CHAPIN, and others, did not disclose

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benefit	to.	the	other	SDCERS	Board	Trustees	in a section of the s

- On or about November 18, 2002, defendants SAATHOFF and aa. LEXIN, and others defended MP2 before the City Council.
- On or about December 6, 2002, defendant LEXIN, and bb. others, drafted a letter that defended MP2 against allegations made publicly that MP2 was "corrupt."
- cc. On or about December 20, 2002, defendant SAATHOFF told the SDCERS Board that under MP1, the City would not have been required to pay SDCERS the funds necessary to restore SDCERS' funding ratio to 82.3% if the funding ratio fell below 82.3%.
- dd. On or about August 15, 2003, defendant SAATHOFF, during a SDCERS Board meeting, falsely denied that he had received increased benefits as a result of MP2.

All in violation of Title 18, United States Code, Section 371.

Counts 2 - 5

18 U.S.C. §§ 1343, 1346, and 2

Honest Services Wire Fraud

- 29. The allegations set forth in paragraphs 1 through 24 above are realleged as if fully set forth herein.
- 30. Beginning in or before January 2001, and continuing up to and including January 6, 2006, within the Southern District of California, and elsewhere, defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN did knowingly devise and intend to devise a 27 material scheme and artifice to defraud, to wit, to act with the intent to deprive the SDCERS Board Trustees, members of SDCERS, and

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The Scheme to Defraud

- 31. It was part of the scheme to defraud that defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN, and others, did, among other things, the following:
- Defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN, and others, fraudulently devised a plan to modify MP1 and its trigger in sufficient time so the City would avoid making the imminent multi-million dollar balloon payment to SDCERS that MPl required.
- Defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN, and others, fraudulently agreed to obtain the presidential leave retirement benefit for defendant SAATHOFF in exchange for his support of a proposal to modify MP1 so the City would avoid the imminent multi-million dollar balloon payment that it owed SDCERS under MP1.
- Defendants SAATHOFF, LEXIN, and WEBSTER, and others, negotiated and agreed to accept increased retirement benefits, including defendant SAATHOFF's requested presidential leave retirement benefit and the increase in the retirement multiplier from 2.25% to 2.5% for general members, in exchange for their support of a proposal to modify MP1 so the City would avoid the multi-million dollar balloon payment that it owed SDCERS under MP1.
- Defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN, and others, fraudulently concealed material information about the increased retirement benefits, including defendant SAATHOFF's presidential leave retirement benefit, from SDCERS Board Trustees, so

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1 that the other SDCERS Board Trustees would vote to approve the 2 modification of MP1, which would allow the City to avoid the imminent multi-million dollar balloon payment that it owed SDCERS, would allow the defendants and others to receive increased retirement benefits, including defendant SAATHOFF's presidential leave retirement benefit, and would allow defendants LEXIN, WEBSTER, GRISSOM, and CHAPIN to maintain their positions with the City and SDCERS.

- Defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, CHAPIN, and others, fraudulently concealed material information concerning MP2 and other proposals from SDCERS Board Trustees, so that the other SDCERS Board Trustees would vote to approve the modification of MPI, which would allow the City to avoid the imminent multi-million dollar balloon payment that it owed SDCERS, would allow the defendants and others to receive increased retirement benefits, including defendant SAATHOFF's presidential leave retirement benefit, and would allow defendants LEXIN, WEBSTER, GRISSOM, and CHAPIN to maintain their positions with the City and SDCERS.
- Defendants SAATHOFF, LEXIN, and GRISSOM, and others, fraudulently concealed from the SDCERS Board a prearranged plan for defendant SAATHOFF to submit his MP2 proposal, which, if approved, quaranteed defendant SAATHOFF his presidential leave retirement benefit.
- Defendants SAATHOFF, LEXIN, and WEBSTER, and others, fraudulently voted in favor of defendant SAATHOFF's MP2 proposal, and by concealing material information from the other SDCERS Board Trustees, defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN deceived and fraudulently induced the other SDCERS Board Trustees to vote in favor of defendant SAATHOFF's MP2 proposal, which would allow

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1 the City to avoid the imminent multi-million dollar balloon payment 2 that it owed SDCERS, would allow the defendants and others to receive increased retirement benefits, including defendant SAATHOFF's presidential leave retirement benefit, and would allow defendants LEXIN, WEBSTER, GRISSOM, and CHAPIN to maintain their positions with 6 the City and SDCERS.

- Defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN, and others, drafted and assisted in the drafting of legislation implementing defendant SAATHOFF's MP2 proposal and the contingent retirement benefits negotiated in 2002, knowing that defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN, and others had concealed material information from the SDCERS Board Trustees, including the nature and existence of the presidential leave retirement benefit.
- Defendants SAATHOFF, GRISSOM, and CHAPIN, and others, 16 fraudulently concealed from SDCERS Board Trustees material information concerning defendant SAATHOFF's purchase of service credits that enhanced defendant SAATHOFF's retirement benefits.
- By deceiving the SDCERS Board Trustees and fraudulently i. 20 concealing material information from SDCERS Board Trustees, defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN caused significant harm to the financial integrity of SDCERS.

Execution Of The Scheme

32. On or about the dates set forth below, according to each count, within the Southern District of California, and elsewhere, defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN, for the purpose of executing the aforesaid material scheme to defraud, knowingly transmitted and caused to be transmitted by means of a wire

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communication	in	interstate	commerce	, certain	writings,	signs,
signals, and s	ounds	s, that is,	e-mails,	as alleged	below:	rund wilder in in in earl

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3	COUN	T DATE	WIRE COMMUNICATION
4	2	6/19/2002	E-mail entitled "Fwd: Report," sent from an e-mail account located in San Diego, California, to an America Online e-mail account of an SDCERS
5		·	Board Trustee, located in Dulles, Virginia
6 7	3	7/8/2002	E-mail entitled "City's Proposal re SDCERS," sent from an e-mail account located in San Diego, California, to an America Online e-mail
8			account of an SDCERS Board Trustee, located in Dulles, Virginia
9	4.	7/15/2002	E-mail entitled "Re: He's Baaack!," sent by
10			defendant GRISSOM from an e-mail account located in San Diego, California, to an America Online e-mail account of an SDCERS Board Trustee,
11			located in Dulles, Virginia
12	5	10/4/2002	E-mail entitled "Resolution for Incumbent
13			Presidential Retirement Benefits, " sent from an e-mail account located in San Diego, California,
14			to an America Online e-mail account of defendant SAATHOFF, located in Dulles, Virginia
15			
16	All	in violation of	Title 18, United States Code, Sections 1343, 1346
17	and	2.	

18 U.S.C. §§ 1341, 1346, and 2

Honest Services Mail Fraud

- 33. The allegations set forth in paragraphs 1 through 24 above are realleged as if fully set forth herein.
- 34. Beginning in or before January 2001, and continuing up to and including January 6, 2006, within the Southern District of California, and elsewhere, defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN did knowingly devise and intend to devise a material scheme and artifice to defraud, to wit, to act with the intent to deprive the SDCERS Board Trustees, members of SDCERS, and

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The Scheme to Defraud

- 35. It was part of the scheme to defraud that defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN, and others, did, among other things, the following:
- Defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN, and others, fraudulently devised a plan to modify MP1 and its trigger in sufficient time so the City would avoid making the imminent multi-million dollar balloon payment to SDCERS that MP1 required.
- Defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and b. CHAPIN, and others, fraudulently agreed to obtain the presidential leave retirement benefit for defendant SAATHOFF in exchange for his support of a proposal to modify MP1 so the City would avoid the imminent multi-million dollar balloon payment that it owed SDCERS under MP1.
- Defendants SAATHOFF, LEXIN, and WEBSTER, and others, negotiated and agreed to accept increased retirement benefits, including defendant SAATHOFF's requested presidential retirement benefit and the increase in the retirement multiplier from 2.25% to 2.5% for general members, in exchange for their support of 24 a proposal to modify MP1 so the City would avoid the multi-million dollar balloon payment that it owed SDCERS under MP1.

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- Defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, CHAPIN, and others, fraudulently concealed material information concerning MP2 and other proposals from SDCERS Board Trustees, so that the other SDCERS Board Trustees would vote to approve the modification of MP1, which would allow the City to avoid the imminent multi-million dollar balloon payment that it owed SDCERS, would allow the defendants and others to receive increased retirement benefits, including defendant SAATHOFF's presidential leave retirement benefit, and would allow defendants LEXIN, WEBSTER, GRISSOM, and CHAPIN to maintain their positions with the City and SDCERS.
- Defendants SAATHOFF, LEXIN, and GRISSOM, and others, fraudulently concealed from the SDCERS Board a prearranged plan for defendant SAATHOFF to submit his MP2 proposal, which, if approved, guaranteed defendant SAATHOFF his presidential leave retirement benefit.

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Defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and h. CHAPIN, and others, drafted and assisted in the drafting of legislation implementing defendant SAATHOFF's MP2 proposal and the contingent retirement benefits negotiated in 2002, knowing that defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN, and others 18 had concealed material information from the SDCERS Board Trustees, 19 including the nature and existence of the presidential leave retirement benefit.

- i. Defendants SAATHOFF, GRISSOM, and CHAPIN, and others, 22 fraudulently concealed from SDCERS Board Trustees material information concerning defendant SAATHOFF's purchase of service credits that enhanced defendant SAATHOFF's retirement benefits.
- By deceiving the SDCERS Board j. Trustees and fraudulently concealing material information from SDCERS Board 27 Trustees, defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN caused significant harm to the financial integrity of SDCERS.

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Execution Of The Scheme

36. On or about the dates set forth below, according to each count, within the Southern District of California, and elsewhere, defendants SAATHOFF, LEXIN, WEBSTER, GRISSOM, and CHAPIN, for the purpose of executing the aforesaid material scheme to defraud, knowingly deposited and caused to be deposited matters and things to be sent and delivered by private and commercial interstate carriers, and caused matters and things to be delivered by the United States Postal Service and private and commercial interstate carriers according to the direction thereon as alleged below:

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11	COUNT	DEFENDANTS	DATE	MAIL MATTER		
12	6	SAATHOFF	6/13/2002	SDCERS Board Packet For June 21, 2002 SDCERS Board Meeting,		
13		LEXIN WEBSTER		Delivered to SDCERS Board Trustee		
14		GRISSOM CHAPIN		via Adcom Express		
15	7	SAATHOFF LEXIN	6/13/2002	SDCERS Board Packet For June 21, 2002 SDCERS Board Meeting,		
16		WEBSTER GRISSOM		Delivered to SDCERS Board Trustee via Adcom Express		
17		CHAPIN		VIG ACCOM EXPICES		
18	8	SAATHOFF	6/13/2002	SDCERS Board Packet For June 21, 2002 SDCERS Board Meeting,		
19		WEBSTER GRISSOM		Delivered to SDCERS Board Trustee via Adcom Express		
20		CHAPIN		VII 11000 IMPI (35		
21	9	SAATHOFF	7/9/2002	SDCERS Board Packet For July 11, 2002 SDCERS Board Meeting,		
22		WEBSTER GRISSOM		Delivered to SDCERS Board Trustee via Adcom Express		
23		CHAPIN				
24	10	SAATHOFF	7/9/2002	SDCERS Board Packet For July 11, 2002 SDCERS Board Meeting,		
25		WEBSTER GRISSOM		Delivered to SDCERS Board Trustee via Adcom Express		
26		CHAPIN				

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1	COUNT	DEFENDANTS	DATE	MAIL MATTER			
3	11	SAATHOFF LEXIN WEBSTER GRISSOM CHAPIN	7/9/2002	SDCERS Board Packet For July 11, 2002 SDCERS Board Meeting, Delivered to SDCERS Board Trustee via Adcom Express			
5 6 7	12	SAATHOFF	8/12/2002	Check No. 013011081 For \$3,529.89, payable to San Deigo [sic] City Employees Ret Sys FBO Ronald L Saathoff, Delivered to SDCERS via United States Mail			
8 9 10	13	SAATHOFF	8/12/2002	Check No. 013010714 For \$8,090.44, payable to San Deigo [sic] City Employees Ret Sys FBO Ronald L Saathoff, Delivered to SDCERS via United States Mail			
11	14	SAATHOFF	8/29/2002	Check No. 78697 For \$1,736.71, payable to SDCERS PLAN, Delivered to SDCERS via United States Mail			
13 14 15	15	SAATHOFF	9/13/2002	Check No. 2583879 For \$51,236.79, payable to City of San Diego For Plan to Plan Transfer FBO Ronald Saathoff, Delivered to SDCERS via United States Mail			
16 17 18	16	SAATHOFF LEXIN WEBSTER GRISSOM CHAPIN	11/7/2002	SDCERS Board Packet For November 15, 2002 SDCERS Board Meeting, Delivered to SDCERS Board Trustee via Adcom Express			
19 20 21	17	SAATHOFF LEXIN WEBSTER GRISSOM CHAPIN	11/7/2002	SDCERS Board Packet For November 15, 2002 SDCERS Board Meeting, Delivered to SDCERS Board Trustee via Adcom Express			
22 23 24	18	SAATHOFF LEXIN WEBSTER GRISSOM CHAPIN	11/7/2002	SDCERS Board Packet For November 15, 2002 SDCERS Board Meeting, Delivered to SDCERS Board Trustee via Adcom Express			
25 26 27	19	SAATHOFF LEXIN WEBSTER GRISSOM CHAPIN	11/7/2002	SDCERS Board Packet For November 15, 2002 SDCERS Board Meeting, Delivered to SDCERS Board Trustee via Adcom Express			
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1	COUNT	DEFENDANTS	DATE	MAIL MATTER			
3 4	20	SAATHOFF LEXIN WEBSTER GRISSOM CHAPIN	11/7/2002	SDCERS Board Pac November 15, 200 Meeting, Deliver Board Trustee vi	D2 SDCERS Board red to SDCERS	1	
5				. ,			
6	All in v	violation of T	itle 18, Un	ited States Code,	Sections 1341,	1346	
7	and 2.						
8	DA:	TED: January	6, 2006.		•		
9				A TRUE BILL:			
10			,		•		
11		•		***************************************		***************************************	
12		** ** * * *		Foreperson	•		
13	CAROL C. LAM United States Attorney						
14							
15	By:						
16	G. MICHAEL STILL Special Assistant U.S. Attorney						
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18	Ву:					•	
19		HN B. OWENS sistant U.S.	Attorney		·		
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UNITED STATES OF AMERICA Before the SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933 Release No. 8751 / November 14, 2006

SECURITIES EXCHANGE ACT OF 1934 Release No. 54745 / November 14, 2006

ADMINISTRATIVE PROCEEDING File No. 3-12478

In the Matter of

City of San Diego, California,

Respondent.

ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against the City of San Diego, California (the "City" or "Respondent").

II.

In anticipation of the institution of these proceedings, the City has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, the City consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

On the basis of this Order and the City's Offer, the Commission finds that:¹

A. SUMMARY

This matter involves the City of San Diego's violations of the antifraud provisions of the federal securities laws in connection with the offer and sale of over \$260 million in municipal bonds in 2002 and 2003. At the time of these offerings, City officials knew that the City faced severe difficulty funding its future pension and health care obligations unless new revenues were obtained, pension and health care benefits were reduced, or City services were cut. The City's looming financial crisis resulted from (1) the City's intentional under-funding of its pension plan since fiscal year 1997; (2) the City's granting of additional retroactive pension benefits since fiscal year 1980; (3) the City's use of the pension fund's assets to pay for the additional pension and retiree health care benefits since fiscal year 1980; and (4) the pension plan's less than anticipated earnings on its investments in fiscal years 2001 through 2003.

Despite the magnitude of the problems the City faced in funding its future pension and retiree health care obligations, the City conducted five separate municipal bond offerings, raising more than \$260 million, without disclosing these problems to the investing public. In each of these offerings, the City prepared disclosure documents that are used with municipal securities offerings—that is, preliminary official statements and official statements—and made presentations to rating agencies.² In addition, in 2003 it prepared and filed information pursuant to continuing disclosure agreements under Exchange Act Rule 15c2-12 with respect to \$2.29 billion in outstanding City bonds and notes.³ Although the City provided some disclosure about its pension and retiree health care obligations, it did not reveal the gravity of the City's financial problems, including that:

• The City's unfunded liability to its pension plan was expected to dramatically increase, growing from \$284 million at the beginning of fiscal year 2002 and \$720

¹ The findings herein are made pursuant to the City's offer of settlement and are not binding on any other person or entity in this or any other proceeding.

² An official statement is a document prepared by an issuer of municipal bonds that discloses material information regarding the issuer and the particular offering. A preliminary official statement is a preliminary version of the official statement that is used to describe the proposed new issue of municipal securities prior to the determination of the interest rate(s) and offering price(s). The preliminary official statement may be used to gauge interest in an issue and is often relied upon by potential purchasers in making their investment decisions.

³ Continuing disclosures are disclosures of material information relating to prior years' municipal bond offerings that are periodically provided to the marketplace by the bonds' issuer pursuant to contractual agreements and Exchange Act Rule 15c2-12.

- million at the beginning of fiscal year 2003 to an estimated \$2 billion at the beginning of fiscal year 2009;
- The City's total under-funding of the pension plan was also expected to increase dramatically, growing tenfold from \$39.2 million in fiscal year 2002 to an estimated \$320 to \$446 million in fiscal year 2009;
- The City's projected annual pension contribution would continue to grow, from \$51 million in 2002 to \$248 million in 2009; and
- The estimated present value of the City's liability for retiree health benefits was \$1.1 billion.

The City's enormous pension and retiree health liabilities and failure to disclose those liabilities placed the City in serious financial straits. When the City eventually disclosed its pension and retiree health care issues in fiscal year 2004, the credit rating agencies lowered the City's credit rating. The City also has not obtained audited financial statements for fiscal years 2003, 2004, and 2005.

Consequently, the City violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit the making of any untrue statement of material fact or omitting to state a material fact in the offer or sale of securities.⁴

B. THE RESPONDENT

City of San Diego, California is a California municipal corporation with all municipal powers, functions, rights, privileges, and immunities authorized by the California Constitution and laws, including the power to issue debt. The City is the seventh most populous city in the country, with approximately 1.3 million residents.

C. RELATED PARTY

San Diego City Employees' Retirement System ("CERS") is a defined benefit plan⁵ established by the City to provide retirement, disability, death, and retiree benefits to its members,

⁴ The Commission acknowledges that in the City's offering documents for sewer revenue bonds issued in 1995, 1997, and 1999 and sewer revenue bonds that were offered but not issued in 2003, in its continuing disclosures, and in its communications with rating agencies, the City failed to disclose that the City's wastewater fee rate structure did not comply with certain federal and state clean water laws, that the City was not in compliance with the terms of certain government grants and loans, and that the City could have been required to repay those grants and loans due to such non-compliance. The offerings in the 1990s, however, predate the offerings that are the subject of this Order, and the City did not consummate the 2003 offering because issues arose regarding the adequacy of its pension disclosure. In addition, in 2004, the City came into compliance with the federal and state clean water laws and the grant and loan covenants by adopting a new fee rate structure. The City thereby avoided having immediately to repay the government grants and loans.

⁵ A defined benefit plan is a traditional pension plan under which pre-determined retirement benefits are based on a formula established by factors such as age, years of service, and

i.e., City employees and their beneficiaries. CERS is administered by the CERS Board, which during the relevant period included eight City employees, including the City Treasurer and the Assistant City Auditor and Comptroller, one retiree, and three non-employee City citizens appointed by the City Council as CERS Board members.

D. FACTS

1. Background

a. Structure of the City's Government

Until January 2006, the City's form of government was a city manager system. Legislative powers of the City were vested in the City Council ("Council"), which made policies and appointed a professional city manager to carry out those policies. The Council was composed of nine full-time Council members who served for staggered four-year terms. Eight of the Council members represented the City's eight districts. The Mayor, who was elected at large, presided at the meetings of the Council and served as the official head of the City for ceremonial purposes. The Mayor and each Council member had one vote; the Mayor had no veto power.

Prior to 2006, the City Manager ("Manager") was the City's chief administrative officer and had substantial control over local government decisions. The Manager, appointed by the Mayor and Council, advised the Council of the City's present and projected financial condition, appointed and removed all city department heads (except the City Auditor and Comptroller ("City Auditor"), City Attorney, and City Clerk), prepared the City's budget, and carried out the Council's budget plan. During the relevant time period, the City's general fund budget was less than \$900 million. The City Manager had several Deputy City Managers, one of whom was in charge of the Financing Services Department, which had responsibility for overseeing the City's issuance of municipal securities.

Prior to 2006, the City Auditor was also appointed by the Council, and was required to file at least monthly with the City Manager and Council a summary statement of revenues and expenses for the preceding accounting period. The Auditor was the City's chief financial officer and was responsible for the preparation and issuance of the City's Comprehensive Annual Financial Reports, also referred to as CAFRs. The City's Comprehensive Annual Financial Reports included audited financial statements prepared pursuant to standards established by the

compensation, and in which the employer bears risk if the employer and employee contributions and the investment return on those contributions are not sufficient to fund the pension benefits.

⁶ In January 2006, the City transitioned from a City Manager / Council form of government to a strong Mayor form of government. Under the new system, the Mayor became the City's chief executive officer and the City Manager's position was eliminated. The Council continues to act as the legislative body. City of San Diego City Charter, Article XV.

⁷ City of San Diego City Charter, Article V, Section 39.

Government Accounting Standards Board ("GASB")⁸ and various statistical, financial, and other information about the City. Portions of the Comprehensive Annual Financial Reports for the years ended June 30, 2001, and June 30, 2002 were attached as appendix B to the preliminary official statements and the official statements. The Comprehensive Annual Financial Reports for 2001 and 2002 were also filed as continuing disclosures.

The elected City Attorney served as the chief legal officer for the City. The City Attorney's office advised the Council, City Manager, and all City departments on legal matters, including disclosure in the City's securities offerings. The City Attorney was responsible for preparing all ordinances, resolutions, contracts, and other legal documents.

b. The City's Pension Plan

The City provided a defined benefit pension plan and retiree health care benefits to its employees through CERS. CERS functioned as a trust for the benefit of its members (i.e., approximately 18,500 current and former City employees and officials). The City was the creator of the trust and determined its terms, including the members' required contributions and the levels of benefits. CERS was administered by a Board of Administration, which controlled the investment of CERS's funds and which owed fiduciary duties to CERS members. CERS's assets consisted of past contributions by the City and CERS members and investment earnings on those funds. CERS's liabilities consisted of operating expenses and the future pension benefits that were owed to members.

Each year, CERS hired an actuary to determine the value of the plan's assets and liabilities based on certain actuarial assumptions and the amount that needed to be contributed to the plan so that the plan accumulated sufficient assets to pay pension (but not health care) benefits when due. ⁹ Pursuant to the City Charter, the City was to contribute half of that amount, which was expressed in terms of a percentage of payroll expenses, with the other half to be contributed by the employees, which amount was determined as a percentage of compensation based on the employee's age upon entry into CERS.

At least three concepts were particularly important in the disclosure to the public of the City's pension obligations and funding of those obligations: (1) CERS's funded ratio; (2) the

⁸ GASB is the organization that establishes standards of state and local governmental accounting and financial reporting.

⁹ An actuarial valuation is a determination by an actuary, as of a specified date, of the normal cost, actuarial accrued liability, actuarial value of the assets, and other relevant values for a pension plan based on certain actuarial assumptions. The actuarial value of assets refers to the value of cash, investments, and other property belonging to a pension plan as used by the actuary for the purpose of preparing the actuarial valuation for the pension plan. The actuarial accrued liabilities are what is owed in connection with past services, as determined by one of the actuarial cost methods. Actuarial assumptions are estimates of future events with respect to certain factors affecting pension costs, including rates of mortality, disability, employee turnover, retirement, rates of investment income, and salary increases. Actuarial assumptions are generally based on past experience, often modified for projected changes in conditions.

City's unfunded liability to CERS; and (3) the City's net pension obligation, also called the NPO. CERS's funded ratio was the ratio of its assets to liabilities. The City's unfunded liability to CERS was the dollar shortfall between CERS's assets and liabilities. The City's net pension obligation was the cumulative difference between what the City actually contributed to CERS and the amount that the City would have contributed had it conformed to a funding method recognized by GASB.

2. The City's Pension and Retiree Health Care Benefits and Funding of CERS

The City failed to disclose material information regarding substantial and growing liabilities for its pension plan and retiree health care and its ability to pay those obligations in the future in the disclosure documents for its 2002 and 2003 offerings, in its continuing disclosures filed in 2003, and in its presentations to the rating agencies. As more fully described below, the City's substantial and growing pension and retiree health care liabilities resulted from several factors, including: (1) the City's intentional under-funding of its annual pension contribution; (2) the City's granting of new retroactive pension benefits; (3) the City's use of certain CERS earnings to pay for various additional pension and retiree health care benefits and to pay a portion of employees' pension contributions; and (4) CERS's earning less than anticipated returns on its investments.

a. The City's Historical Practice of Using "Surplus Earnings" to Fund Pension and Retiree Health Care Benefits

In fiscal year 1980, the City began instructing CERS to use "surplus earnings"—i.e., earnings above the actuarially projected 8% return rate¹⁰—to fund an ever-increasing amount of additional benefits for CERS members. Pension plans typically retain surplus earnings to support the plan's financial soundness and to make up for years in which earnings fall short of the assumed return rate. Rather than retaining its surplus earnings, the City began using surplus earnings in fiscal year 1980 to fund an annual extra or "13th check" to retirees. The City continued using surplus earnings to pay for retiree health care benefits in fiscal year 1982 and to pay an ever-increasing amount of the employees' CERS contributions in fiscal year 1998. ¹¹

In total, the City used surplus earnings to pay pension benefits and employees' contributions totaling \$150 million as of the end of fiscal year 2001 and an additional \$25 million as of the end of fiscal year 2002. According to a 2005 CERS audit, the City's use of surplus

¹⁰ Without regard to its actual historical rate of return on investments, the CERS Board assumed an annual rate of investment return of 8%, which the actuary incorporated into his calculations. CERS defined surplus earnings as the amount of realized investment earnings in excess of the actuarially projected 8% return rate.

¹¹ In fiscal years 2003 and 2004, the City used CERS's surplus earnings from prior years to pay up to 27% of the employees' contributions.

earnings accounted for 17% of the increase in the City's unfunded liability to CERS from fiscal year 1997 through fiscal year 2003.

b. Manager's Proposal 1: The City Proposes Additional Benefits in Exchange for Contribution Relief

In fiscal year 1996, the City agreed to increase significantly and retroactively all employees' pension benefits. The City, however, could not afford to fund the cost of the benefit increases. The City therefore made the pension benefit increases contingent on CERS's agreement to the City's under-funding of its annual contribution to CERS.

In fiscal year 1997, the City and CERS entered into an agreement, which was referred to as Manager's Proposal 1, that set the City's annual contribution at gradually increasing rates through fiscal year 2008. This funding method, which the City termed "Corridor" funding, was not recognized by GASB and set annual funding rates that were not actuarially determined and were projected to be below GASB-recognized funding rates through fiscal year 2006. In other words, under Corridor funding, the City would be intentionally under-funding its annual liability to CERS in fiscal years 1997 through 2006. After fiscal year 2006, it was estimated that the funding rate of Manager's Proposal 1 would equal a GASB-accepted rate. Manager's Proposal 1 also contained a provision intended to protect CERS's financial soundness. Specifically, if CERS's funded ratio fell below 82.3%, the City would have to increase its CERS contribution rate.

In fiscal years 1996 and 1997, the City estimated that under Manager's Proposal I, by the end of fiscal-year 2008, the City's net pension obligation would be \$110.35 million. Because the City's Corridor funding method was not GASB-recognized, GASB required that the City disclose its net pension obligation in its annual financial statements.

c. The *Corbett* Litigation Requires the City to Fund Additional Retroactive Benefits

In March 2000, the City again retroactively increased pension benefits. Specifically, the City and CERS settled a class action lawsuit brought by CERS members, with *Corbett* as the named class plaintiff.¹³ Under the *Corbett* settlement, the City retroactively gave increased pension benefits to both current and retired City employees, increasing CERS's liabilities. Under

Manager's Proposal 1 was viewed skeptically by some members of the CERS Board who were not City employees. The majority of the CERS Board, however, consisted of City officials who received benefit increases that were contingent on the Board's approval of Manager's Proposal 1. Moreover, CERS's actuary informed the CERS Board that Manager's Proposal 1 was a sound proposal and CERS's fiduciary counsel opined that the Board would be acting within the ambit of its fiduciary discretion in approving Manager's Proposal 1.

¹³ The *Corbett* plaintiffs raised various claims based on a 1997 California Supreme Court decision which held that an employee's salary for purposes of calculating basic pension benefits included the value of overtime and accrued leave.

Manager's Proposal 1, however, the City's contributions to CERS did not increase. As a result, the City's unfunded liability to CERS increased by \$185 million.

In negotiating the *Corbett* settlement, however, the City purposefully structured certain of the increased *Corbett* benefits to avoid having those benefits adversely affect CERS's reported funded ratio and the City's reported unfunded liability to CERS. Specifically, the City structured the *Corbett* settlement so that the increased benefits for retired CERS members were to be paid in a given year only if there were sufficient surplus earnings from that year to pay the benefit. If there were insufficient surplus earnings in a given year to pay the increased benefit, then the cost of the increased benefit would become CERS's liability and would eventually be paid from future years' surplus earnings. The City and CERS treated the increased benefits to retired CERS members as contingent liabilities that were not taken into account in determining CERS's funded ratio or the City's unfunded liability to CERS. As of June 30, 2001, according to CERS's actuary, if the contingent portion of the *Corbett* settlement had been included in CERS's valuation, the City's unfunded liability to CERS would have increased by \$70 to \$76 million and CERS's funded ratio would have decreased by 2% to 2½% from what was actually reported by the City. Thus, the City's pension situation was even more dire than the numbers, as they were reported by the City, indicated.

d. CERS's Actuary Report for Fiscal Year 2001 Shows a Dramatic Increase in the City's Pension Liabilities

In fiscal year 2001, CERS's investment return began to fall short of its anticipated 8% annual return. The City was informed of CERS's declining performance in February 2002, when it received CERS's annual actuarial valuation for fiscal year 2001. This report stated that as of the end of fiscal year 2001, CERS's funded ratio was 89.9% and the City's unfunded liability to CERS was \$284 million, as compared to a funded ratio of 97.3% and an unfunded liability of \$69 million only one year earlier. Moreover, the report noted that if the *Corbett* contingent benefit to CERS retired members were included, the City's unfunded liability to CERS would have increased to at least \$354 million and CERS's funded ratio would have fallen to at least 87.9%.

CERS's actuary attributed these changes to a number of factors, including CERS's actuarial investment losses of \$95.6 million (and warned that there would be further actuarial investment losses in fiscal year 2002 unless the markets improved during the remaining five months of the fiscal year). In his report, CERS's actuary also warned that "all parties" should be "acutely aware that the current practice of paying less than the [actuarial] computed rate of contribution ... will help foster an environment of additional declines in the funded ratio in absence of healthy investment returns."

In May 2002, the City learned that CERS would likely not have any surplus earnings from fiscal year 2002 to pay for the contingent benefits—specifically, retiree health care benefits, the 13th check, and the *Corbett* increase to retirees.

¹⁴ Actuarial investment losses are the difference between the assumed investment rate, which in the City's case was 8% annually, and the actual investment results.

e. The Blue Ribbon Committee Report Puts the City on Notice about its Growing Pension and Retiree Health Care Liabilities

In April 2002, the City received a warning that the City's pension and retiree health care liabilities would continue to grow and that the City was not adequately planning to meet those liabilities. This came in the form of a report from the City's Blue Ribbon Committee to the City Council. 15 The report stated that the Blue Ribbon Committee had three principal concerns regarding CERS. First, the City was granting retroactive retirement benefit increases but pushing the cost of those benefit increases into the future, long after the individuals involved in the decisions were gone. Second, the City's budgetary process did not adequately comprehend the steadily growing annual expense of the pension contribution, "particularly given the uncontrollable and non-discretionary nature of this liability." The Committee stated that the City's pension contribution would substantially increase and warned that any future benefit increases, particularly retroactive increases, would "significantly exacerbate this problem." Third, the City's budgetary process did not recognize that retiree health care costs were a non-discretionary expense that would grow at an increasing rate and that the City was not paying out of its current year's budget the full cost for their future retiree health benefits. This report thus squarely put the City on notice that it had substantial future pension and healthcare liabilities it would probably be unable to pay under the current system.

f. Manager's Proposal 2: The City Again Proposes Additional Pension Benefits in Exchange for Relief from an Impending Lump Sum Payment

In fiscal year 2003, the City again increased its pension liability by granting additional retroactive benefits, used additional CERS assets to pay for additional pension and retiree health care benefits and an increased portion of the employees' contribution, and obtained additional time to under-fund its annual CERS contribution.

In the second half of fiscal year 2002, the City agreed to increase pension benefits for fiscal year 2003. From as early as October 2001, however, the City was concerned that CERS's funded ratio would fall below the 82.3% floor established by Manager's Proposal 1, which would require the City, at the very least, to increase its contributions to CERS by at least \$25 million to be at a higher GASB-accepted rate.

Concerned about having to pay the additional \$25 million, the City sought to condition the pension benefit increases on the City's obtaining from CERS relief from the floor of Manager's Proposal 1. In November 2002, the City and CERS agreed to Manager's Proposal 2 and the City

¹⁵ In April 2001, the Mayor had appointed a nine-member committee of San Diego citizens, known as the Mayor's Blue Ribbon Committee on City Finances, to independently evaluate the City's fiscal health and make any appropriate recommendations. In February 2002, the Blue Ribbon Committee presented its report to the Council's Rules Committee, identifying nine areas of concern, two of which related to the City's pension fund. The same report was made to the full Council in April 2002.

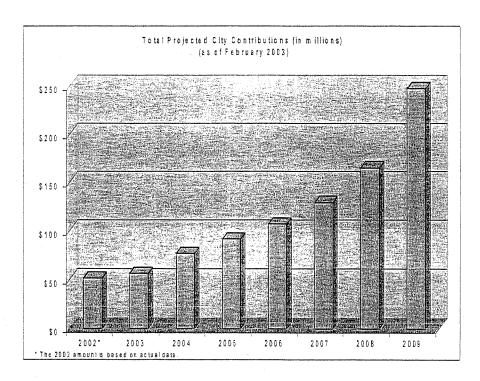
adopted the increased pension benefits as of July 2002. Under Manager's Proposal 2, once CERS's funded ratio fell below 82.3%, the City would have five years to increase its contributions to CERS to reach a GASB-recognized funding rate.

As a result of CERS's actuarial losses in fiscal year 2002, CERS did not have surplus earnings to pay the 13th check, the cost of retiree health care, and the *Corbett* benefit increase to retired CERS members. In conjunction with Manager's Proposal 2, however, the City directed CERS to use certain of its reserve accounts to pay the 13th check and the retiree health care benefits, and to pay an increased portion of certain City employees' CERS contributions. The reserve funds could have been used to increase CERS's funded ratio and decrease the City's unfunded liability to CERS; instead, the City directed that CERS use the reserve funds to pay additional benefits.

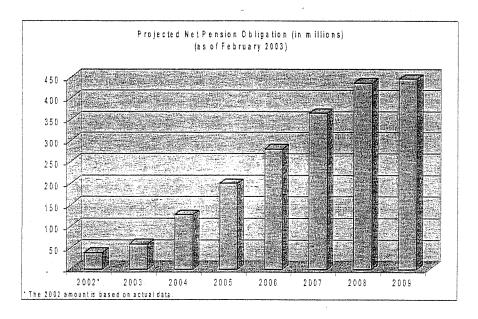
g. CERS's Actuary Report for Fiscal Year 2002 and Projections for the Future Show that the City Faces Substantial Problems Funding its Pension and Retiree Health Care Liabilities

In early 2003, the City received two reports from CERS's actuary. These reports provided the City with negative information regarding the present and projected status of CERS's funded ratio and the City's unfunded liability to CERS. First, in January 2003, the City received CERS's actuary report for fiscal year 2002. This report stated that during fiscal year 2002, CERS suffered an actuarial loss of \$364.8 million and that as of the end of fiscal year 2002, CERS's funded ratio was 77.3% and the City's unfunded liability to CERS was \$720 million, as compared to a funded ratio of 89.9% and unfunded liability of \$284 million only one year earlier. The actuary's report further stated that if the *Corbett* contingent benefit to CERS retired members had been included, the City's unfunded liability to CERS would have been at least \$790 million, and CERS's funded ratio would have been approximately 75.3%. In the concluding comment, the actuary stated that CERS was "in adequate condition," which was the first time that the actuary had not described CERS as "actuarially sound."

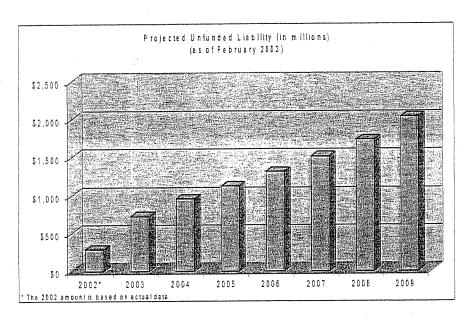
Second, in February 2003, CERS's actuary provided to the City projections of the City's contributions under Manager's Proposal 2, the City's net pension obligation, the City's unfunded liability to CERS, and CERS's unfunded ratio. Specifically, the City's contribution rate was projected to more than quadruple—from 9.83% of payroll in fiscal year 2002 (\$51 million) to 35.27% of payroll in fiscal year 2009 (\$248 million). The following chart illustrates the growth in the City's projected annual contribution to CERS:



The City's net pension obligation was projected to grow by tenfold—from \$39.23 million in fiscal year 2002 to as much as \$446 million in fiscal year 2009. The following chart illustrates the growth in the City's projected net pension obligation:



The City's unfunded liability was projected to increase more than seven fold—from \$284 million at the beginning of fiscal year 2002 to \$2 billion at the beginning of fiscal year 2009. CERS's funded ratio was projected to continue to fall—from 77.3% at the beginning of fiscal year 2003 to 65.6% at the beginning of fiscal year 2009. The following chart illustrates this dramatic increase in the City's projected unfunded liability to CERS:



The City had knowledge of these projections prior to all of its 2003 municipal securities offerings.

h. The Gleason Litigation: CERS

Members Challenge Manager's Proposal 1 and

Manager's Proposal 2

Further evidence that the City's under-funding of CERS was potentially threatening the City's future fiscal health came in January 2003, when CERS members filed a class action, with *Gleason* as the named class plaintiff, against the City and CERS alleging breaches in connection with the City's under-funding of CERS under Manager's Proposal 1 and Manager's Proposal 2. Among other things, the *Gleason* complaint alleged that by 2009, the City would owe approximately \$2.8 billion to CERS, with an annual City budget expense of more than \$250 million. In March 2003, the CERS attorney in the *Gleason* litigation advised CERS that (1) certain CERS Board members had breached their fiduciary duty by adopting Manager's Proposal 2; and (2) CERS should exercise its right to nullify Manager's Proposal 2. The CERS Board, which included the City Treasurer and the Assistant City Auditor and Comptroller, rejected this advice. If Manager's Proposal 2 had been nullified, the City would have been required to make an immediate potential payment to CERS of up to \$159 million.

i. CERS's Response to the Blue Ribbon Committee Report Advises the City's Officials of the Growing Pension and Retiree Health Care Crisis.

In February 2003, additional detailed information about the City's pension funding crisis was presented to City officials when CERS responded to the Blue Ribbon Committee's report. ¹⁶ In its response, CERS advised the City that as of June 30, 2002, CERS's funded ratio had fallen to 77.3% and the City's unfunded liability to CERS had increased to \$720 million. The response also stated that the falling funded ratio and the increasing unfunded liability resulted from three factors: a dramatic decline in CERS's investment performance in fiscal years 2001 and 2002; the City's granting of increased benefits; and the City's contributions to CERS at less than a GASB-recognized rate.

With respect to the City's under-funding, the response stated that the annual amount of the City's under-funding of CERS continued to increase in fiscal years 2002 and 2003, which was contrary to the initial projections from Manager's Proposal 1 that the annual amount of underfunding would decline beginning in fiscal year 2001. The response further stated that the City's net pension obligation would reach \$102 million by the end of fiscal year 2003 and \$423 million by the end of fiscal year 2009.

The response also discussed the City's future liability for retiree health care. CERS's actuary had estimated that the present value of the City's liability for future retiree health care was in excess of \$1.1 billion. The response further stated that the City was not making any contributions to CERS to pay for this liability, that CERS had been paying for this liability with money in a reserve funded with CERS's surplus earnings from prior years, that the reserve would be depleted in fiscal year 2006, and that in fiscal year 2006, the City would have to pay an estimated \$15 million for retiree health care. The response warned that absent a change in the benefit and a dramatic decrease in future health care costs, the City could be facing significant future funding obligations. The response recommended that the City consider funding this future health care liability as part of its annual contribution to CERS.

j. The City's Study of Its Pension Obligations Concludes that the City's Pension Liabilities Could Negatively Impact the City's Credit Rating

In April 2003, the City received additional information regarding the projected growth of its future pension liabilities and the possible negative effect those liabilities would have on the City's credit rating and ability to issue municipal securities. In February 2003, the City hired a financial adviser to analyze CERS's funding and to develop potential solutions. On April 16,

¹⁶ From February 9 through 13, 2003, the local newspaper wrote three front page, above-the-fold articles about the City's under-funded pension system and the CERS response. The newspaper articles explained that (1) by the end of FY 2009 the City's unfunded liability to CERS was projected to increase to almost \$2 billion; and (2) the City's unfunded liability for retiree health care was estimated to be \$1.1 billion.

2003, the financial adviser provided to the City a preliminary pension analysis. In its analysis, the financial adviser stated that because of the City's under-funding, the City's unfunded liability would continue to grow and CERS's funded ratio would continue to fall through fiscal year 2021 regardless of actuarial gains or losses. The financial adviser estimated that under Manager's Proposal 2, the City's unfunded liability to CERS would grow to \$1.9 billion at the end of fiscal year 2009 and to \$2.9 billion at the end of fiscal year 2021, and CERS's funded ratio would fall to 66.5% at the end of fiscal year 2009 and would be 67% at the end of fiscal year 2021.

The preliminary pension analysis also stated that the City's large unfunded liability to CERS would cause the City's contribution to CERS to increase dramatically. The analysis estimated that the City's contribution rate to CERS would more than double—from 18.87% of payroll (or \$107.5 million) in fiscal year 2004 to 40.9% of payroll (\$286.9 million) in fiscal year 2009.

The preliminary pension analysis also discussed the effect that the City's unfunded liability would have on the City's credit rating. The financial adviser stated that the City's current unfunded liability would not only trigger an adverse credit event but that the rating agencies would expect the City to develop a plan to reduce its unfunded liability by increasing its annual contributions and/or funding the unfunded liability by issuing bonds. The financial adviser further stated that if the City did not develop and implement such a plan, the City's unfunded liability could cause the City "significant credit and legal challenges." The City's disclosures in 2003 failed to inform investors of the financial adviser's analysis.

- 3. The Offerings, Continuing Disclosures, and Rating Agency Presentations
 - a. The Bond Offerings and the City's Preparation of the Offerings' Disclosure Documents

During 2002 and 2003, the City conducted the following five municipal securities offerings totaling \$261,850,000 in par value:

- \$25,070,000 Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds, Series 2002B (Fire and Safety Project) (June 2002)
- \$93,200,000 City of San Diego, 2002-03 Tax Anticipation Notes Series A (July 2002)
- \$15,255,000 City of San Diego/Metropolitan Transit Development Board Authority 2003 Lease Revenue Refunding Bonds (San Diego Old Town Light Rail Transit Extension Refunding (April 2003)
- \$17,425,000 City of San Diego 2003 Certificates of Participation (1993 Balboa Park/Mission Bay Park Refunding) (May 2003)
- \$110,900,000 City of San Diego 2003-04 Tax Anticipation Notes Series A (July 2003)

A transactional financing team prepared the offering documents, that is, the preliminary official statement and the official statement, for each of the five municipal bond offerings. The

financing team consisted of outside consultants and officials from the City Manager's office (financing services division), Auditor and Comptroller's office, and the City Attorney's office. The outside consultants included, among others, bond counsel, disclosure counsel, and underwriters. The preliminary official statement and the official statement for each of the five offerings consisted of a description of the offering, a general description of the City, including financial, economic, statistical, and other information in appendix A, and audited annual financial statements from the City's Comprehensive Annual Financial Reports in appendix B. Information regarding its pension and retiree health care obligations was provided in both appendices A and B.

The outside consultants took the lead in drafting the description of the bond offerings. City officials in the financing services division were responsible for drafting appendix A. The financing services division updated Appendix A on an ongoing basis and at the time of a bond offering, forwarded the latest version of Appendix A to the entire financing team. The team met several times to review, comment on, and ultimately finalize the preliminary official statements and official statements at "page-turner meetings." Appendix B was prepared by the Auditor's office and the City's outside auditor. The Council approved all of the 2002 and 2003 offerings at open session meetings.

b. The Continuing Disclosures

During the relevant period, the City also filed annual continuing disclosures relating to its \$2.29 billion in outstanding bonds for the purpose of updating investors on the state of the City's finances. 17 City officials in the financing services division coordinated, reviewed, and filed the 2002 and 2003 continuing disclosures. Almost all of these continuing disclosures included appendix A and portions of the City's Comprehensive Annual Financial Reports. The financing services division was responsible for ensuring that the most updated and accurate version of appendix A was attached to the continuing disclosures before they were filed.

c. The 2003 Rating Agency Presentations

The City made presentations to the rating agencies on a yearly basis, both in connection with specific bond offerings and to update the rating agencies on the City's general credit. The presentations were made orally with PowerPoints in meetings with representatives from Fitch Ratings, Moody's Investors Service, and Standard and Poor's. In 2003, the rating agencies specifically asked the City to address the pension plan as part of its annual presentations. These presentations were important because they directly affected the City's bond ratings. The 2003

¹⁷ An underwriter of municipal securities covered by Exchange Act Rule 15c2-12 may not purchase or sell municipal securities in connection with an offering unless the issuer has undertaken in a written agreement or contract for the benefit of the bondholders to provide its audited annual financial statements and certain other annual financial and operating information, to nationally recognized municipal securities information repositories and state information depositories designated by the Commission and to provide notices of certain material events and notices of any failures to file on the nationally recognized municipal securities information repositories or the Municipal Securities Rulemaking Board and state information depositories.

PowerPoint presentations were prepared and presented by officials from the City Manager's office, including the financing services division, and the City Auditor and Comptroller's office. The financing services division drafted the pension portion of the 2003 PowerPoint presentation. Officials from the City Auditor's office made the oral presentation on the pension plan and fielded numerous questions on that topic from the rating agencies.

4. The False and Misleading Disclosures

In the preliminary official statement and the official statements for the 2002 and 2003 offerings, the 2003 presentations to the rating agencies, and the 2003 continuing disclosures, the City made substantial disclosures regarding (1) the City's policies for funding CERS; and (2) the status of CERS's funding and the City's liability to CERS. Additionally, in the preliminary official statements, the official statements, and continuing disclosures, the City made certain representations regarding its retiree health care obligations. The disclosures (collectively "Disclosures"), however, were misleading because the City failed to include material information regarding the City's current funding of its pension and retiree health care obligations, the City's future pension and retiree health care obligations, and the City's ability to pay those future obligations.

First, with respect to the pension issues, the City failed in the Disclosures to reveal several material facts, including that (1) the City was intentionally under-funding its pension obligations so that it could increase pension benefits but push off the costs associated with those increases into the future; (2) because of the City's under-funding of its pension plan, its net pension obligation was expected to continue to grow at an increasing rate, reaching from \$320 million to \$446 million by the end of fiscal year 2009; (3) the City's unfunded liability was expected to continue to grow at a substantial rate, reaching approximately \$2 billion by fiscal year 2009; (4) this growth in the City's unfunded liability resulted from the City's intentional under-funding of its pension plan, the City's granting of new retroactive pension benefits, the City's use of pension plan earnings to pay additional benefits, and the pension plan's less than anticipated investment return; (5) the City's annual pension contribution was expected to more than quadruple by fiscal year 2009; and (6) the City would have difficulty funding its future annual pension contributions unless it obtained new revenues, reduced pension benefits, or reduced City services. Moreover, the City falsely disclosed in Appendix B to its preliminary official statements and its official statements that its net pension obligation was funded in a reserve.

Additionally, with respect to retiree health care benefits, the City failed to disclose in its preliminary official statements, official statements, and continuing disclosures that (1) the estimated present value of its liability for retiree health care was \$1.1 billion; (2) the City had been covering the annual cost for retiree health care with pension plan earnings from prior years that were expected to be depleted in fiscal year 2006; (3) after fiscal year 2006, the City would have to pay for the retiree health care benefits from its own budget at an estimated annual cost of \$15 million; and (4) the City had not planned for paying such additional costs.

¹⁸ The issue of retiree health care was not addressed in the rating agency presentations.

5. The City's Knowledge of the Misleading Disclosures

The City, through certain of its officials, knew that its Disclosures were misleading. The Mayor and Council were responsible for approving the issuance of the bonds and notes, including issuance of the preliminary official statements and official statements. The Mayor and Council delegated final approval of the official statements to the City Manager. The City Manager's office was responsible for the preparation of the preliminary official statements and the official statements, including appendix A. The City Auditor's office was responsible for the preparation of appendix B to the preliminary official statements and official statements. Through their designees on the CERS Board, among other things, both the City Manager's and the City Auditor's offices had knowledge about the City's use of CERS's surplus earnings, Manager's Proposals 1 and 2, CERS's actuary reports for fiscal years 2001 and 2002, and CERS's response to the Blue Ribbon Committee Report. Also, several representatives of the City Manager's office, City Attorney's office, and Auditor and Comptroller's office attended relevant closed session meetings of the Council where Manager's Proposals 1 and 2 and the Corbett and Gleason litigations were discussed. Moreover, the Blue Ribbon Committee Report and CERS's response to the Blue Ribbon Committee Report were both presented to a committee of the Council at which officials from the City Manager's and Auditor and Comptroller's office were present. Finally, the offices of the City Manager and the City Auditor were responsible for the City's study of its pension obligations that occurred in early 2003. Through their participation and involvement in the abovereferenced matters, certain city officials knew or were reckless in not knowing that the Disclosures were false and misleading.

Specifically, by early 2002, the City, through its officials, knew, among other things, that (1) CERS's funded ratio would likely fall below the 82.3% floor set by Manager's Proposal 1; (2) the City was proposing Manager's Proposal 2 to avoid the effects of CERS's falling below the floor; (3) Manager's Proposal 2 allowed the City more time to under-fund CERS; and (4) the Blue Ribbon Committee had raised concerns about the City's under-funding of CERS and the future retiree health care liability. By early 2003, the City, through its officials, knew, among other things, that (1) the City's projected total contributions to CERS would grow from \$77 million in fiscal year 2004 to \$248 million in fiscal year 2009; (2) CERS had fallen below the 82.3% floor of Manager's Proposal 1; (3) the City and CERS had adopted Manager's Proposal 2 to allow the City more time to under-fund CERS; and (4) CERS was using reserved surplus earnings to pay certain benefits and to pay an increased portion of the employees' CERS contribution.

6. Materiality and the City's Voluntary Disclosure

The misleading Disclosures were material in view of the City's overall financial health. The Disclosures were also material given the magnitude of the City's projected annual CERS payments in the future and the potential consequences of those liabilities to the City, including inability to make the payments without reduction in other services.

The nature and level of under-funding brought into question the City's ability to fund the pension and health care benefits in the future as well as its ability to repay the bonds and notes. Under such a scenario, the City could be forced to choose between paying pension contributions, paying what the City owes on its bonds and notes, reducing services, and/or raising fees and taxes.

The materiality of the misleading Disclosures was demonstrated by the impact on the City's bond ratings when it finally disclosed key facts about the pension plan on January 27, 2004 in a voluntary report of information, after a non-employee CERS Board member raised concerns about the City's disclosure. The voluntary report provided information regarding (1) CERS's current and estimated future funded status; (2) the City's current and estimated future liabilities to CERS; (3) the reasons for the substantial decrease in CERS's funded ratio and increase in the City's liability to CERS; (4) the City's previous use of CERS funds to pay for retiree health care and the City's estimated future liabilities for retiree health care; and (5) the City's anticipated difficulty funding its increasing CERS contribution without new City revenues, a reduction in pension benefits, a reduction in City services, or other actions. Shortly after the disclosures in the voluntary report, the rating agencies lowered their ratings on the City's bonds and notes.

E. Legal Discussion

1. The Securities Act and Exchange Act Antifraud Provisions

State and local governments are exempt from the registration and reporting provisions of the Securities Act and the Exchange Act. Similarly, the Commission's authority to establish rules for accounting and financial reporting under Section 19 of the Securities Act and Section 13(b) of the Exchange Act does not extend to municipal securities issuers. The City and other municipal securities issuers, however, are subject to the antifraud provisions of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. In addition, the Commission has promulgated a broker-dealer rule, Exchange Act Rule 15c2-12, which in general limits market access for certain municipal securities issues to those offerings in which the issuer agrees to file annual financial disclosures of specified financial and operating information as well as notices of certain events, if material, and notices of any failures to file with repositories designated by the Commission. The antifraud rules apply to such disclosure and to any other statements made to the market.

Section 17(a) of the Securities Act prohibits misrepresentations or omissions of material facts in the offer or sale of securities. Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit misrepresentations or omissions of material fact in connection with the purchase or sale of any security. These provisions prohibit the making of any untrue statement of material fact or omitting to state a material fact in the offer, purchase, or sale of securities. A fact is material if there is a substantial likelihood that its disclosure would be considered significant by a reasonable investor. Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1987); TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 require a showing that defendants acted with scienter. <u>Aaron v. SEC</u>, 446 U.S. 680, 701-02 (1980). Scienter is "a mental state embracing intent to deceive, manipulate or defraud." <u>Ernst & Ernst v. Hochfelder</u>, 425 U.S. 185, 193 n.12 (1976). In the Ninth Circuit, recklessness satisfies the scienter requirement. <u>Hollinger v. Titan Capital Corp.</u>, 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc). Recklessness is "an extreme departure from the standards of ordinary care, and which presents a danger of misleading [investors] that is either known to the defendant or is so obvious

that the actor must have been aware of it." <u>Id.</u>, 914 F.2d at 1569. Scienter, however, need not be shown to establish a violation of Section 17(a)(2) or (3). <u>Aaron v. SEC</u>, 446 U.S. 680, 697 (1980). Violations of these sections may be established by showing negligence. <u>SEC v. Hughes Capital Corp.</u>, 124 F.3d 449, 453-54 (3d Cir. 1997); <u>SEC v. Steadman</u>, 967 F.2d 636, 643 n. 5 (D.C. Cir. 1992).

2. The City's Violations of the Antifraud Provisions of the Securities Act and the Exchange Act

The City's public disclosures in the preliminary official statements and official statements for its 2002 and 2003 offerings, its 2003 continuing disclosures, and presentations to the rating agencies failed to disclose material information regarding the City's current funding of its pension and retiree health care obligations, the City's future pension and retiree health care obligations, and the City's ability to pay those future obligations. The omission of this information caused the information that was disclosed to be misleading.

This information was material to investors. The magnitude of the City's unfunded liabilities was enormous. For example, the City knew that by 2009 the unfunded liability would reach \$1.9 billion and its actuarially required contribution would be approximately \$240 million compared to \$51 million in FY 2002. The City's under-funding of CERS and unfunded liabilities to CERS and for retiree health care were projected to continue to grow at an increasing rate. The increase in the City's under-funding and unfunded liabilities resulted, in part, from the City's decisions to increase pension and retiree health care benefits but push the costs of those increases into the future, to use CERS's prior earnings to cover additional benefits, and to pay a portion of the employees' contribution to CERS. All of this information raised a question whether the City could pay for these pension and retiree health care obligations and repay the bonds and notes issued by and on behalf of the City.

The City, through its officials, acted with scienter. 19 City officials who participated in drafting the misleading disclosure were well aware of the City's pension and retiree health care issues and the magnitude of the City's future liabilities. Moreover, even though the City officials knew that the City's pension issues were of concern to the rating agencies, they failed to disclose material information regarding the City's pension and retiree health care issues. In light of the City's officials' detailed knowledge of the magnitude of the City's pension and retiree health care liabilities and of the rating agencies' interest in those liabilities, the City officials acted recklessly in failing to disclose material information regarding those liabilities.

F. REMEDIAL EFFORTS AND UNDERTAKINGS

1. Since 2005, Respondent has implemented several remedial measures with a view to detect and prevent securities violations. Specifically, the City has terminated certain officials in the City Manager's and Auditor and Comptroller's offices or has allowed them to resign. The City has filled these positions with new employees generally having significant relevant experience with

¹⁹ The City's scienter is based on the mental state of its officials. <u>SEC v. Manor Nursing Centers.</u> <u>Inc.</u>, 458 F.2d 1082, 1089 n.3 (2d Cir. 1972).

other municipal governments or the private sector. The City has hired a full time municipal securities attorney who is responsible for coordinating the City's public disclosure and who has conducted continuing education for the City's deputy attorneys on the City's disclosure requirements.

- 2. The Mayor resigned and has been replaced by a former City police chief. In January 2006, pursuant to a public referendum, the City changed from a strong city manager form of government to a strong mayor form of government.
- 3. The City has hired new outside professionals including new auditors for its fiscal year audits. The City also hired individuals not affiliated with the City to act as the City's Audit Committee and charged the Committee with investigating the City's prior disclosure deficiencies and making recommendations to prevent future disclosure failures. The City has also hired new disclosure counsel for all of its future offerings, who will have better and more continuous knowledge on the City's financial affairs. This disclosure counsel has conducted seminars for City employees on their responsibilities under the federal securities laws.
- 4. The City has also enacted ordinances designed to change the City's disclosure environment. First, the City created a Disclosure Practices Working Group, comprised of senior City officials from across city government. The Working Group is charged with reviewing the form and content of all the City's documents and materials prepared, issued, or distributed in connection with the City's disclosure obligations relating to securities issued by the City or its related entities; and conducting a full review of the City's disclosure practices and to recommend future controls and procedures. Second, the Mayor and City Attorney must now personally certify to the City Council the accuracy of the City's official statements. Third, the City Auditor must annually evaluate the City's internal financial controls and report the results to the City Council.
 - 5. Respondent shall comply with the following undertakings to:
 - a. Retain, not later than 60 days after the date of this Order, at its expense, an independent consultant not unacceptable to the Commission's staff (the "Independent Consultant"). The City shall require the Independent Consultant to (a) conduct annual reviews for a three-year period of the City's policies, procedures, and internal controls regarding its disclosures for offerings, including disclosures made in its financial statements, pursuant to continuing disclosure agreements, and to rating agencies, the hiring of internal personnel and external experts for disclosure functions, and the implementation of active and ongoing training programs to educate appropriate City employees, including officials from the City Auditor and Comptroller's office, the City Attorney's office, the Mayor, and the City Council members regarding compliance with disclosure obligations; (b) make recommendations concerning these policies, procedures, and internal controls with a view to assuring compliance with the City's disclosure obligations under the federal securities laws; and (c) assess, in years two and three, whether the City is complying with its policies, procedures, and internal controls, whether the City has adopted any of the Independent Consultant's recommendations from prior year(s) concerning such policies, procedures, and internal controls for disclosures

- for offerings, and whether the new policies, procedures, and internal controls were effective in achieving their stated purposes;
- b. No later than 10 days following the date of the Independent Consultant's engagement, provide to the Commission staff a copy of an engagement letter detailing the Independent Consultant's responsibilities pursuant to paragraph 5(a) above;
- c. Arrange for the Independent Consultant to issue its first report within 120 days after the date of the engagement and the following two reports within 60 days following each subsequent one-year period from the date of engagement. Within 10 days after the issuance of the reports, the City shall require the Independent Consultant to submit to Kelly Bowers of the Commission's Pacific Regional Office a copy of the Independent Consultant's reports. The Independent Consultant's reports shall describe the review performed and the conclusions reached and shall include any recommendations deemed necessary to make the policies, procedures, and internal controls adequate and address the deficiencies set forth in Section III.D of the Order. The City may suggest an alternative method designed to achieve the same objective or purpose as that of the recommendation of the Independent Consultant provided that the City's Mayor and City Attorney certify in writing to the Commission staff that they have a reasonable belief that the alternative method is expected to have the same objective or purpose as that of the Independent Consultant's recommendation;
- d. Take all necessary and appropriate steps to adopt, implement, and employ the Independent Consultant's recommendations or the City's alternative method designed to achieve the same objective or purpose as that of the Independent Consultant's recommendation; and
- e. Require the Independent Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with the City, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity; provided however, that the Independent Consultant may enter into an agreement with the City to serve as an independent monitor to oversee the City's remedial efforts with respect to enhanced accountability, greater transparency, increased fiscal responsibility, and independent oversight. Except as permitted above, the agreement will also provide that the Independent Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Independent Consultant in performance of his/her duties under this Order shall not, without prior written consent of the Pacific Regional Office, enter into any employment, consultant, attorney-client, auditing or other professional relationship with the City, or any of its present or former affiliates, directors, officers, employees, or agents acting in

their capacity as such for the period of the engagement and for a period of two years after the engagement.

6. In determining whether to accept the City's Offer, the Commission considered these undertakings and remediation measures.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in the City's Offer.

Accordingly, it is hereby ORDERED that:

- A. The City cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; and
- B. The City comply with the undertakings enumerated in paragraph 5 of Section III.F. above.

By the Commission.

Nancy M. Morris Secretary

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8	UNITED STATES	DISTRICT COURT			
9	SOUTHERN DISTRI	CT OF CALIFORNIA			
10	SAN DIEGO POLICE OFFICERS'	CASE NO. 05-CV-1581 H (POR)			
11	SAN DIEGO POLICE OFFICERS' ASSOCIATION, on behalf of itself and on behalf of all of its members,	ORDER:			
12	Plaintiff,	(1) GRANTING CITY AND INDIVIDUAL DEFENDANTS' MOTION FOR SUMMARY			
13		JUDGMENT REGARDING 2005 NEGOTIATIONS;			
14		(2) GRANTING AGUIRRE'S MOTION FOR SUMMARY			
15		JUDGMENT; (3) GRANTING IN PART AND			
16		DENYING IN PART CITY AND INDIVIDUAL DEFENDANTS'			
17	VS.	MOTION FOR SUMMARY JUDGMENT REGARDING			
18		PENSION UNDERFUNDING; (5) GRANTING IN PART AND			
19		DÉNYING IN PART SDCERS' MOTION FOR SUMMARY			
20		JUDGMENT ON GROUNDS OTHER THAN STATUTE OF			
21		LIMITATIONS; (6) DENYING SDCERS'			
22		MOTION FOR SUMMARY JUDGMENT REGARDING THE			
23		STATUTE OF LIMITATIONS; (7) DENYING PLAINTIFF'S			
24	MICHAEL AGUIRRE, et al.,	MOTIONS FOR SUMMARY JUDGMENT REGARDING			
25	Defendants.	DEFENDANTS' AFFIRMATIVE DEFENSES.			
26	On Angust 0, 2005 Disintiff Com Dis	Data Dalias Officers' Association ("SDDO A")			
27	On August 9, 2005, Plaintiff San Diego Police Officers' Association ("SDPOA") filed a complaint against Defendants bringing claims under 42 U.S.C. § 1983 and various				
28	med a complaint against Defendants oringt	ng claims under 42 U.S.C. § 1905 and various			

Pension Reform Proposal," Pension Benefit Guaranty Corporation, Policy, Research and Analysis Deptartment, White Paper, April 6, 2005) at 4.)

SDCERS is managed by a Board of Administration consisting of thirteen members. (Id., Ex. 1 at § 144.) The City Charter sets forth the composition of the board. The City Charter requires that the pension board be comprised of representatives from the City in addition to outside members. (Id.) As to the SDPOA, the City Charter includes a requirement that the board contain a "police safety member of the Retirement System elected by active police safety members." (Id.)

Thomas Rhodes, a San Diego police officer, has been a member of the SDPOA since 1980. (See Pl.'s Corrected Supplemental Not. Ldgmt. Supp. Opp. City and Individual Defs.' Mot. Summary J. Re 2005 Negotiations ("Pl.'s SNOL Re 2005 Negotiations"), Ex. 4 (August 31, 2006 Dep. of Thomas Rhodes ("Rhodes Dep.")) at 16.) He has served as an officer of the SDPOA, serving as secretary, since approximately 1998 or 1999. (Id. at 18.) Thus, he served as secretary of the SDPOA during 2002 and 2003. (Id. at 20.) In or around December of 1999, Rhodes was elected to fill the SDCERS board position reserved for police employees, and he began serving in January 2000. (Id. at 23.) He served on the SDCERS board for approximately three and one half years, ending his tenure in August of 2003. (Id.)

In 2002, the City and the SDPOA were in the midst of labor negotiations. (<u>Id.</u> at 56.) Thomas Rhodes was both the secretary of the SDPOA and an SDCERS board member at that time. (<u>Id.</u> at 16-18 & 23.) He was involved in the labor negotiations between the City and the SDPOA in 2002. (<u>Id.</u> at 56.) The City conditioned any increase in benefits and compensation to the SDPOA's members upon the SDCERS board's approval of contribution relief for the City. (<u>Id.</u> 65, 70, & 71.) On May 9, 2002, during meet and confer negotiations between the City and the SDPOA, representatives of the City Manager's office presented to the SDPOA board, including Rhodes, a proposal. (<u>Id.</u> at 62, 75 & 79.) The proposal sought relief from the 82.3% funding level safety net implemented by an Employer Contribution Rate Stabilization Plan ("MP1")

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1	Additionally, the Court has ordered further briefing from the parties in a separate
2	scheduling order.
3	IT IS SO ORDERED.
4	DATED: May 18, 2007
5	Marilon L. Hull
6	MARILYN L. HUFF, District Judge UNITED STATES DISTRICT COURT
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By: U. JELLISUN, Deputy

SUPERIOR COURT OF CALIFORNIA COUNTY OF SAN DIEGO

SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM, by and through its) CASE NO. GIC 841845
Board of Administration,) STATEMENT OF DECISION) PHASE ONE
Plaintiff,) Judge: Jeffrey B. Barton) Dept: 69
VS.) Trial date: October 30, 2006
SAN DIEGO CITY ATTORNEY MICHAEL J. AGUIRRE, CITY OF SAN DIEGO,	
Defendants.	
AND ALL OTHER RELATED ACTIONS.	_)

Trial of Phase One began on October 30, 2006, and was submitted for decision on November 29, 2006. Intervenors Local 127, American Federation of State, County and Municipal Employees, AFL-CIO ("Local 127"), San Diego City Firefighters, Local 145, and San Diego Municipal Employees Association's ("MEA") and the *Abdelnour* plaintiffs were represented by Ann Smith, Joel Klevins, David Strauss, and Ellen Greenstone. The City of San Diego ("City") was represented by Michael Aguirre, Donald McGrath, and Walter Chung. Plaintiff San Diego City Employees' Retirement System's ("SDCERS" or "board") was represented by Reg Vitek and Michael Leone.

Pension Board. This time the labor negotiations with the unions under the MMBA did not meet with initial success. On May 13, 2002, the City made its last best and final offers to each employee group. (Exhibits 272, 274, 311 and 282.)

The last best and final offer under the MMBA is essentially the final step in the negotiation process. It constitutes a take it or leave it offer by the public entity to the employees. If not accepted, there are hearings before the City Council and then the City can impose terms on the employees. In each of these last best and final offers, the City made retirement benefit increases expressly contingent on funding relief from SDCERS. (See, Exhibit 273 page 2 para. 3, for language similar to that found in all the offers.) The proposal was accepted on these terms by the MEA and Locals 127 and 145. The contingent nature of the proposal was well known to union officials and it was made known to many of the members. (Exhibit 355.) The last best and final offer was apparently not accepted by the San Diego Police Officer's Association ("SDPOA") and terms were imposed by the City.

City Manager Uberaga designated Bruce Herring as the point person in presenting the MP 2 plan to the SDCERS Board. He made several presentations to the Board in June and July of 2002. (Exhibit 276, page 179-197.) Concerns regarding the propriety of the proposal were raised by a number of board members including Mr. Vortman and Ms. Shipione. (Exhibits 65 and 276, pages 179-197.) The concerns covered a wide variety of issues including, but not limited to, whether the board members could approve such a proposal while fulfilling fiduciary duties, whether the pension would be adequately funded and the potential for indemnification of board members by the City from potential litigation exposure (*Id.*)

The City initially wanted the trigger lowered. Under MP 1, it had been set at 82.3%. Under MP 2, the City was proposing it be lowered to 75% while at the same time increasing the rate of contribution

The parties should confer following receipt of the decision on Phases Two and Three of the trial. If the City intends to pursue the remaining MP 2 claims against the remaining participants, then a delay of Phases Two and Three is in order to allow service on the effected participants and time to allow them to prepare to litigate the procedural and substantive issues on the merits. The Court has already scheduled a Status Conference to set a timeline for these further proceedings.

IT IS SO ORDERED.

Dated: January 18, 2007

JEFFREY B. BARTON

JEFFREY B. BARTON
Judge of the Superior Court

-ddj-

Report of the Audit Committee of the City of San Diego

INVESTIGATION INTO THE

SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM

AND THE CITY OF SAN DIEGO SEWER RATE STRUCTURE

AUGUST 8, 2006

ARTHUR LEVITT, JR.
LYNN E. TURNER
TROY A. DAHLBERG

KROLL

WILLKIE FARR & GALLAGHER LLP

V. PARTIES RESPONSIBLE FOR VIOLATIONS OF LAW: PENSION

A. SDCERS

1. The SDCERS Board

An assessment of responsibility for illegal activity at SDCERS must start with the members of the Retirement Board. The Board was ultimately responsible for ensuring that SDCERS was in compliance with its fiduciary obligations to present and future retirees, as well as with all applicable laws and regulations. When it comes to MP-1 and MP-2, the Board failed to live up to its responsibility. By means of MP-1 and MP-2, the City was able to contribute to SDCERS at less than actuarially determined rates which, in conjunction with increased unfunded benefits and poor investment returns, caused SDCERS to become actuarially unsound. In so doing, MP-1 and MP-2 violated, among other things, the San Diego City Charter, the Municipal Code, and the California Constitution.

By voting for MP-1 and MP-2, the SDCERS Board breached its fiduciary duty to the Trust to act with the "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." The Board's fiduciary duty to act in a prudent manner obligated it to investigate facts concerning the funding and maintenance of the system and to disclose that information to the beneficiaries of the system. Further, the Board had a duty to monitor investments and service providers, identify errors, and then act expeditiously to remedy them. So As detailed above, the SDCERS Board failed in

Cal. Const. art. XVI, § 17.

Final Report, City of San Diego Pension Reform Committee at 11 (Sept. 15, 2004).

Donovan v. Mazzola, 716 F.2d 1226, 1231 (9th Cir. 1983) (applying "prudent man" rule as articulated by ERISA but noting that its articulation was based upon common law of trusts). The legal analysis accompanying the Navigant Report reached substantially the same conclusion, finding that, in agreeing to MP-1 and MP-2, the SDCERS Board breached its duty to act prudently in the administration of SDCERS and its duty of loyalty to the members of SDCERS. Reish Luftman Reicher & Cohen, Legal Analysis of Investigative Report on the San Diego City Employees' Retirement System at 79, 94-96 (Jan. 20, 2006). City Attorney Interim Report No. 6 reached much the same conclusion as to the SDCERS Board's approval of MP-1, as did City Attorney Interim Report No. 2 to the SDCERS Board's approval of MP-2. City Attorney Michael J. Aguirre, Amended Interim Report No. 6 Regarding the San Diego City Employees' Retirement System Funding Scheme at 35 (July 1, 2005); City Attorney Michael J. Aguirre, Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego City Officials at 97-99 (Feb. 9, 2005).

Barker v. American Mobil Power Corp., 64 F.3d 1397, 1403 (9th Cit. 1995); City of Oakland v. Public Employees' Retirement Systems, 95 Cal. App. 4th 29, 40 (2002).

Morrissey v. Curran, 567 F.2d 546, 548-49 (2d Cir. 1997); 29 C.F.R. § 2509.9601(c) (2006). Although Morrissey was based on a violation of ERISA, this body of law may be instructive regarding the fiduciary duties of the SDCERS Board. ERISA primarily governs private employee benefit plans maintained by employers or employees engaged in commercial activities and does not apply to governmental plans, such as SDCERS. 29 U.S.C. § 1003(a)-(b). However, given the similarities between the standards enunciated in Cal. Const art. XVI, § 17 and those contained in

each of these duties: the Board failed to investigate the relevant facts related to the consequences of its acquiescence to two illegal funding plans; the Board failed to adequately educate plan beneficiaries of the consequences of the underfunding; and it failed to act expeditiously to correct any of the errors – related to, among other things, MP-1, MP-2, or the underpricing of Purchase of Service Credits – upon discovery. ⁵⁹¹

The Board also violated Article XVI, Section 17 of the California Constitution, which required members of the Board to "discharge their duties with respect to the system solely in the interests of, and for the exclusive purpose of providing benefits to, participants and their beneficiaries" and that "a retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty."⁵⁹²

To be fair, the Board is not solely responsible for MP-1 and MP-2. It sought the advice of outside professionals, both actuarial and legal. It also relied upon a staff of full-time professional employees, including an administrative staff and internal general counsel (for MP-2), to bring to its attention legal or actuarial problems with MP-1 and MP-2. These individuals, insofar as they failed to render unbiased, professionally competent advice or otherwise turned a blind eye to facts indicating that MP-1 and MP-2 were harmful to SDCERS or were in violation of California law, also bear responsibility for the Board's fiduciary breaches, as discussed below. But even if the professionals did not do their job, that does not absolve the Board of responsibility for its own conduct. Although the Board could look to professionals for advice, it had to make its own independent judgment about what was in the best interests of SDCERS, without regard to individual interests of Board members or the competing interests of other constituencies. The Board failed to do this.

ERISA, the fiduciary principles embodied in ERISA shed light on the responsibilities of the SDCERS Board members. 29 C.F.R. § 2550.404a-1 (2006); Cal. Const. art. XVI, § 17. In a memorandum by the City Attorney, a Board's fiduciary duty of prudence under article XVI, section 17 of the California Constitution was equated with the "prudent person" standard defining "a fiduciary's duties and responsibilities to an employee benefit plan governed by the Employee Retirement Income Security Act of 1974 [ERISA]." The City Attorney concluded that while a City's employee benefit plan is a government plan and thus the provisions of ERISA do not apply, "it is likely a court would use the 'prudent person' standard as it has been interpreted for employee benefit plans governed by ERISA in determining [a Board's] fiduciary duty." Memorandum from City Attorney to SPSP/401(K) Trustee Board (Aug. 12, 2004). Therefore, the law of ERISA provides a legal framework for understanding the fiduciary duties of the Board.

City Attorney Michael J. Aguirre has alleged that Mr. Saathoff was instrumental in the decision to refer the purchase of service price setting responsibility to a SDCERS subcommittee – pricing which, as alleged by Mr. Aguirre, was discounted and not based on sound actuarial principles. Second Amended Complaint at 30-33, *People v. Grissom*, No. GIC 850246 (Cal. Super. Ct. Dec. 12, 2005).

The legal analysis accompanying the Navigant Report similarly concluded that the SDCERS Board violated these tenets of the California Constitution by agreeing to MP-1 and MP-2. Reish Luftman Reicher & Cohen, Legal Analysis of Investigative Report on the San Diego City Employees' Retirement System at 79, 93-94 (Jan. 20, 2006). The City Attorney reached a similar conclusion with regard to both MP-1 and MP-2. City Attorney Michael J. Aguirre, Amended Interim Report No. 6 Regarding the San Diego City Employees' Retirement System Funding Scheme at 33 (July 1, 2005); City Attorney Michael J. Aguirre, Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials at 97-99 (Feb. 9, 2005).

⁵⁹³ Cal. Const. art. XVI, § 17(b).

Moreover, when the Board's professional advisors cautioned against certain actions as unwise, unsound, or illegal, the Board frequently ignored them and did the wrong thing anyway. For example, the Board was cautioned by its actuary, Rick Roeder, that the "contingent" *Corbett* liabilities were not truly contingent and would decrease the funded ratio. ⁵⁹⁴ The Board's fiduciary counsel, Constance Hiatt, also advised the Board that the "contingent" *Corbett* liabilities were contingent in name only. ⁵⁹⁵ Notwithstanding this advice, the Board directed its actuary not to include the *Corbett* liabilities in SDCERS's UAAL, for the sole reason that, by excluding these liabilities, SDCERS would be able to report an inflated funded ratio and the City would be able to record a lower NPO. ⁵⁹⁶ This decision benefited the City to the detriment of SDCERS. At a minimum, the Board's intentional decision to understate SDCERS's UAAL breached its fiduciary duty to SDCERS.

Similarly, the Board's conduct when seeking legal advice with respect to MP-1 undermines any confidence that they would have gained from that advice. First, it appears that, in dismissing Morrison & Foerster, its previous counsel, the Board was silencing a potentially dissenting voice, given Morrison & Foerster's lack of receptivity to prior efforts by the City to obtain contribution relief.⁵⁹⁷ More significant, however, was the failure of the Board to seek advice as to the most significant legal issue facing the Board in connection with MP-1, namely its legality. It does not appear fiduciary counsel was even asked to address the legality of MP-1 under the San Diego City Charter, Municipal Code, or the California Constitution.⁵⁹⁸

The situation was even worse when it came to MP-2. There, the evidence suggests the Board's fiduciary counsel, Robert Blum and Constance Hiatt, did not exercise their independent legal judgment at all, but instead took direction from SDCERS Administrator Grissom in advising the Board against MP-2 and, later, reversing course and advising the Board in favor of it. 599 And, unlike MP-1, where the Board's actuary actively supported the measure during Board meetings at which it was discussed,

Minutes, SDCERS Board Meeting at 11, 13 (June 21, 2002); Letter from Rick A. Roeder to Larry Grissom (Mar. 30, 2000).

Letter from Constance M. Hiatt to Loraine E. Chapin, Esq. cc to Lawrence B. Grissom and Robert A. Blum (Apr. 16, 2002).

E-mail from Robert Blum to Larry Grissom cc to Connie M. Hiatt (July 3, 2002); Minutes, SDCERS Board Meeting at 13 (June 21, 2002).

Letter from Morrison & Foerster to Lawrence B. Grissom, Retirement Administrator (May 9, 1995).

Rather, fiduciary counsel was asked only to provide an opinion as to whether the SDCERS Board would be discharging its fiduciary duties to SDCERS by approving MP-1. Letter from Dwight Alan Hamilton, Hamilton and Faatz, and John A. Graham, Frandzel & Share, to Lawrence B. Grissom, Retirement Administrator (June 21, 1996).

E-mail from Sheila Leone to Loraine Chapin (Mar. 24, 2003); Letter from Bob Blum and Connie Hiatt to Frederick W. Pierce, President, Retirement Board (Nov. 18, 2002); Letter from Constance M. Hiatt and Robert Blum to Lawrence Grissom, Retirement Administrator (Draft June 12, 2002).

SDCERS's actuary actually resisted MP-2. ⁶⁰⁰ In fact, had any of the Board members cared enough to ask Mr. Roeder for his honest assessment of MP-2, they would have learned as much. ⁶⁰¹ As it turned out, only one Board member – Diann Shipione – did so. ⁶⁰² This failure to seek guidance on the fiscal propriety of MP-2 from the one person most qualified to give it (actuary Rick Roeder) evidences the Board's abandonment or disregard of its obligation to the retirement system and its beneficiaries. Finally, the insistence by the SDCERS Board that the City indemnify it as a condition of its approval of MP-2 underscores the Board's concern – one they failed properly to address or resolve – that what it was doing may have been illegal or a breach of its fiduciary duty. ⁶⁰³ Indeed, Ms. Shipione asked fiduciary counsel Bob Blum at the June 21, 2002 Board meeting how the Board could be indemnified knowing it had breached its fiduciary duty. ⁶⁰⁴ Then, less than six months after the adoption of MP-2, the Board's new outside counsel advised it that MP-2 was illegal and the Board should blame its adoption on pressure from the City. ⁶⁰⁵ The Board either knew, or should have known, that its conduct was at best improper and at worst illegal.

The following Retirement Board members voted for MP-1 on June 21, 1996: Keith Enerson, Bruce Herring, Sharon Wilkinson, Terri Webster, Robert Scannell, Ron Saathoff, John Torres, and Conny Jamison. Each of these individuals, in voting to approve MP-1, breached their fiduciary duties to

Letter from Rick Roeder, Fellow of the Society of Actuaries, to Councilman Scott Peters (Aug. 12, 2004); Letter from Reg A. Vitek, Seltzer Caplan McMahon Vitek, to Sheila Leone, Esq. cc to Michael A. Leone, Esq. (Mar. 5, 2003); Letter from Rick A. Roeder to Larry Grissom, Retirement Administrator (Nov. 5, 2002); Minutes, SDCERS Board Meeting at 28 (June 21, 1996); Minutes, SDCERS' Retirement Board of Administration Special Workshop at 15 (June 11, 1996).

Letter from Rick Roeder, Fellow of the Society of Actuaries, to Councilman Scott Peters (Aug. 12, 2004); Letter from Reg A. Vitek, Seltzer Caplan McMahon Vitek, to Sheila Leone, Esq. cc to Michael A. Leone, Esq. (Mar. 5, 2003); Letter from Rick A. Roeder to Larry Grissom, Retirement Board Administrator (Nov. 5, 2002); E-mail from Constance Hiatt to Lawrence Grissom cc to Bob Blum (July 18, 2002).

E-mail from Constance Hiatt to Lawrence Grissom cc to Bob Blum (July 18, 2002) (in which Ms. Hiatt discussed Mr. Roeder's conversation with Ms. Shipione regarding the modified MP-2 proposal adopted by the Board on July 11, 2002, noting that Mr. Roeder "spoke 'candidly' with Diane [sic], not only as an actuary and suggested if she were sufficiently outraged, she and other likeminded board members should wage a campaign to have voters approve all benefit increases as they do in SF."). Mr. Roeder testified that he may have spoken to Ms. Shipione and he would have likely explained that, although MP-2 did not represent a best practices approach, the plan in the long run would not have necessarily precluded the System from reaching a funded ratio near 100%. Transcript of Preliminary Hearing at 1232, 1235, People v. Lexin, No. CD 190930 (Cal. Super. Ct. Dec. 7, 2005).

Minutes, SDCERS Board Meeting at 22 (Nov. 15, 2002); Minutes, SDCERS Board Meeting at 28-29 (July 11, 2002); Minutes, SDCERS Board Meeting at 26-27 (June 21, 2002); E-mail from Robert Blum to Loraine Chapin, Lawrence Grissom and Paul Barnett cc to Connie M. Hiatt (July 15, 2002).

Minutes, SDCERS Board Meeting at 26 (June 21, 2002).

Letter from Reg A. Vitek, Seltzer Caplan McMahon Vitek, to Sheila Leone, Esq. cc to Michael A. Leone, Esq. (Mar. 5, 2003).

Minutes, SDCERS Board Meeting at 31 (June 21, 1996). SDCERS Board members Jack Katz, Ann Parode, and Paul Barnett voted against the proposal.

SDCERS for all of the reasons set forth above. Likewise, the Board members who voted for MP-2 on July 11, 2002 – Ronald Saathoff, John Casey, Mary Vattimo, Frederick Pierce, Sharon Wilkinson, John Torres, Cathy Lexin, and Terri Webster – also breached their fiduciary duties to the SDCERS Trust. 607

In addition to breaches of fiduciary duty, the SDCERS Board's approval of MP-1 and MP-2 also implicated California's conflict of interest laws. When the Board voted to approve the funding arrangements embodied in MP-1 and MP-2, on which the retirement benefits negotiated between the City and the labor unions were "contingent," the Board essentially wielded "veto" power over those benefits. As a result, the Board members who were also pension plan participants (*i.e.*, City employees) voted to approve a contract in which they held a financial interest – namely, their own enhanced pension benefits.

California Government Code Section 1090 ("Section 1090") prohibits a public official from entering into a contract, in his official capacity, in which he has a financial interest. Section 1090 contains a "salary exemption," which provides that benefits constituting "salary" will not be considered "disqualifying financial interests" when they are disclosed to the rest of the decision-making body, noted in that body's official record, and the contract is approved without counting the votes of the interested members. Even if enhanced pension benefits are considered "salary," this exemption is unavailable to the conflicted members of the SDCERS Board because their financial interests were not disclosed in the manner required by Section 1090, and they participated in the Board votes to approve MP-1 and MP-2. The "rule of necessity," which permits public officials to enter into contracts which may otherwise be within the ambit of conflict of interest laws when the application of such laws would impede the vital public duties of a decision-making body, does

Minutes, SDCERS Board Meeting at 38 (July 11, 2002). For the July 11, 2002 vote, Ray Garnica abstained, Tom Rhodes and David Crow voted no, and Richard Vortmann and Diann Shipione were not present. Minutes, SDCERS Board Meeting at 38 (July 11, 2002). For the November 15, 2002 vote, Diann Shipione and Tom Rhodes voted no and Cathy Lexin was not present. Minutes, SDCERS Board Meeting at 30 (Nov. 15, 2002).

Cathy Lexin, Ron Saathoff, John Torres, Mary Vattimo, Terri Webster, and Sharon Wilkinson have argued that the July 11, 2002 vote for MP-2 did not constitute an agreement with the City because the Board was completely free to withdraw from MP-2 if a final written contract could not be agreed upon or if its fiduciary counsel or actuary later disapproved of it. Memorandum of Points and Authorities in Support of Motion to Set Aside Information Pursuant to Penal Code Section 995, *People v. Lexin*, No. SCD 190930, at 52-55 (Cal. Super. Ct. June 30, 2006).

In late July, after Ms. Lexin had already voted for the proposal at the July 11, 2002 SDCERS Board meeting, Mr. Blum noticed that the possibility existed that Ms. Lexin was conflicted because she was currently negotiating the agreement that she was voting on as a Board member. E-mail from Robert Blum to Lawrence Grissom, Paul Barnett and Loraine Chapin cc to Connnie M. Hiatt and Marcus Wu (July 30, 2002). In the end, Ms. Lexin did not participate in the vote regarding MP-2 at the November 15, 2002 SDCERS Board meeting. Minutes, SDCERS Board Meeting at 30 (Nov. 15, 2002).

⁶⁰⁹ Cal. Gov't Code § 1090 (Deering 2006).

Cal. Gov't Code § 1091(b)(13) (Deering 2006).

not insulate the SDCERS Board's actions. While the Board was required to enter into funding agreements with the City in order to fulfill its administrative duties, it was *not* required to accept these particular funding agreements which improperly tied increased benefits to contribution relief. Thus, the SDCERS Board violated Section 1090 by approving MP-1 and MP-2.

Cathy Lexin, Ron Saathoff, John Torres, Mary Vattimo, Terri Webster, and Sharon Wilkinson have argued that they did not violate Section 1090 by voting for MP-2 because retirement benefits are part of a public official's salary, the California Constitution required members of the SDCERS Board to consider benefits to members as part of their fiduciary duties, the Charter required them to sit on the Board and make decisions which entailed conflicts of interests, and they had no financial interest in MP-2. They have also stated that neither Mr. Blum, the City Attorney's Office nor any other counsel ever told any Board member that they would be violating Section 1090 by voting on MP-2. Memorandum of Points and Authorities in Support of Motion to Set Aside Information Pursuant to Penal Code Section 995, *People v. Lexin*, No. SCD 190930, at 12, 55-57, 64-77, 82 (Cal. Super. Ct. June 30, 2006). However, the presiding judge found during a preliminary hearing that there was probable cause to believe that those defendants violated Section 1090 when they voted for MP-2. The judge explained that the defendants agreed to the City's contribution relief in exchange for increased personal benefits. He stated:

It's like they did everything that they could to give the relief here. The interesting thing is why. Why? The carrot was the contingency. . . . [A]t meet-and-confer it was said that these benefits are contingent. They knew that. There were folks on the Board that were a part of the meet-and-confer process and they knew that these benefits were contingent upon the Board's relief. In other words, the City did not want to pay that big balloon payment. . . Why are [the defendants] going through this? It's like they are so hot to get this rate relief for the City. What's the reason for it? . . . And the big word that keeps jumping up here is contingent, contingent, contingent. It was contingent in May, it was contingent in June, it was contingent in July. And as Mr. Ewell said, the rate increases were "always" contingent upon rate relief. . . . They were financially interested in this agreement because it increased their pension benefits.

The Court noted that the defendants had "significant" defenses to the charges of Section 1090 violations, but that those defenses could not obliterate the elements of such a violation at the preliminary hearing stage. Reporter's Preliminary Hearing Transcript, *People v. Lexin*, No. SCD 190930, at 2575-2577 (Cal. Super. Ct. Jan. 13, 2006).

In its 2005 Report, Vinson & Elkins mentioned potential conflict of interest issues under Section 1090 with regards to the Board's approval of MP-1 and MP-2, but did not reach a conclusion on this issue. Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 29-31, 70-73 (Draft July 15, 2005).

Cal. Gov't Code § 87101; Finnegan v. Schrader, 91 Cal. App. 4th 572, 582-583 (Cal. Ct. App. 2001) ("If the board has a legal duty to enter into a particular contract in which one of its members has a financial interest, the rule of necessity may come into play.").

In an action brought by the State of California against Cathy Lexin, Ron Saathoff, John Torres, Mary Vattimo, Terri Webster, and Sharon Wilkinson, the presiding judge found during a preliminary hearing that there was probable cause to believe that those defendants violated Section 1090. The judge stated that the Rule of Necessity did not apply in that case because the defendants did not have a duty to act. He explained that the SDCERS Board's duties did not include voting on the setting of salaries or pension benefits. Reporter's Preliminary Hearing Transcript, People v. Lexin, No. 190930, at 2581 (Cal. Super. Ct. Jan. 13, 2006).

See Finnegan v. Schrader, 91 Cal. App. 4th 572, 582-583 (Cal. Ct. App. 2001).

Apparently, however, City Attorney Casey Gwinn advised the City Council in 2003 that it was not a violation of Section 1090 or the Political Reform Act to vote on retirement benefits. Councilmember Peters and Former Mayor Murphy's Memorandum of Points and Authorities in Support of Motion to Disqualify the City Attorney, To Quash Subpoenas and for a Protective Order, San Diego Employees' Ret. Sys. v. Aguirre, No. GIC 841845, at 4 (Cal. Super. Ct. Apr. 24, 2006).

The Political Reform Act ("PRA") also prohibits public officials from entering into contracts in which they have a financial interest. In contrast to Section 1090, under the PRA, a public official has a disqualifying financial interest only if he would receive a benefit from the contract that is distinguishable from the benefits received by the public generally. It is therefore likely the PRA would not apply to the actions of those Board members who received the same pension benefit increases as other plan participants. At the very least, however, the Presidential Leave benefits contained in MP-2 were not shared with the plan participants generally as they only impacted three union presidents.

In his Interim Report No. 3, City Attorney Aguirre concluded that, with regards to Section 1090, MP-1, and MP-2 "were carried out in a manner contrary to law." City Attorney Michael J. Aguirre, Interim Report No. 3 Regarding Violations of State and Local Laws as Related to the SDCERS Pension Fund at 14 (Apr. 9, 2005). In a civil action, City Attorney Aguirre has alleged that Lawrence Grissom, Ron Saathoff, John Torres, Sharon Wilkinson, Terri Webster, Cathy Lexin, Bruce Herring, and Loraine Chapin had conflicts of interest when they participated in or influenced the decisions leading to MP-1 and MP-2. Those decisions, according to Mr. Aguirre, placed the defendants in an advantageous position to receive, among other things, a greater percentage share of the SDCERS pension funds than other pension participants. Second Amended Complaint, *People v. Grissom*, No. GIC 850246, at 1-6 (Cal. Super. Ct. Dec. 12, 2005). Mr. Aguirre raised similar allegations in a cross-complaint against SDCERS that the implementation of MP-1 and MP-2 enhanced the pension benefits for former Board members Ron Saathoff, John Torres, Mary Vattimo, Terri Webster, and Sharon Wilkinson in violation of California Government Code § 1090. Third Amended Cross Complaint, *San Diego City Employees' Ret. Sys. v. Aguirre*, No. GIC 841845 (Cal. Super. Ct. Jan. 27, 2005).

- Cal. Gov't Code § 81000 et seg.
- 615 Cal. Gov't Code § 87103.
- In its 2005 Report, Vinson & Elkins mentioned potential conflict of interest issues under the PRA with regards to the Board's approval of MP-1 and MP-2, but did not reach a conclusion on this issue. Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 29-31, 70-73 (Draft July 15, 2005).

In his Interim Report No. 3, City Attorney Aguirre concluded that "[t]aken as a whole, the PRA was not followed." City Attorney Michael J. Aguirre, Interim Report No. 3 Regarding Violations of State and Local Laws as Related to the SDCERS Pension Fund at 16 (Apr. 9, 2005). This Report stated that "it can be argued that a material financial interest would not exist under the PRA because the financial interest felt by the general members of the Board would be equally felt by a large number of other City employees," but nonetheless found that the PRA's salary exception "was not designed to cover to [sic] the egregious and flagrant self-dealing seen here and would not likely apply." Id. at 16. This Report also found that the Presidential Leave benefits conferred upon Ronald Saathoff "were anything but ordinary, and did not affect a large group." Id. Similarly, Terri Webster was one of only approximately 300 plan participants who benefited from a provision in the MP-2 benefit enhancements allowing employees who joined the City before age 24 to be "grandfathered" and thereby excluded from the cap which restricted an individual's pension benefits. We believe this benefit was not "shared by the public generally," and therefore Ms. Webster violated the PRA in voting to approve MP-2. City Attorney Aguirre also concluded that this benefit was not shared by the public generally, and was therefore a disqualifying interest under the PRA. City Attorney Michael J. Aguirre, Interim Report No. 3 Regarding Violations of State and Local Laws as Related to the SDCERS Pension Fund at 15-16 (Apr. 9, 2005). City Attorney Aguirre advanced these and other conclusions in a lawsuit brought on behalf of the City of San Diego against Council members Michael Zucchet and Ralph Inzunza and former Mayor Richard Murphy. The City claimed that some or all of the defendants had violated Section 1090 and the PRA by, among other things, modifying the Legislative Officers' Retirement Plan ("LORP") and the Elected Officer's Retirement Plan ("EORP"). However, the case was voluntarily dismissed by the City Attorney, without prejudice, after the presiding justice stated at a hearing that Mayor Murphy and Council members Zucchet and Inzunza were improperly named as defendants. The Court explained that the named defendants did not modify the Municipal Code and individual Council members had no legal authority to bind the City by adopting an ordinance. Judgment of Dismissal and Award of While it is difficult to assign degrees of responsibility among the various Board members insofar as their actions as Board members are concerned, Mr. Saathoff's backing of MP-2 stands out as being particularly egregious. As the President of the Firefighters' Union, the longest serving member on the SDCERS Board, and the most prominent of the union elected Board members, Mr. Saathoff was viewed by the City officials as critical to gaining SDCERS's support of MP-2 – especially in light of the fact that SDCERS's professional advisors were opposed. It appears the City effectively "bought" Mr. Saathoff's support for MP-2 by providing him with the generous Presidential Leave benefit enhancement package that increased his yearly pension benefit, upon his retirement or participation in the Deferred Retirement Option Program, by approximately \$30,000 annually. In accepting this unique financial benefit, Ron Saathoff violated the PRA by voting to approve MP-2.

Costs, City of San Diego v. Murphy, No. GIC 854373 (Cal. Super. Ct. Mar. 27, 2006); Plaintiff's Supplemental Brief, City of San Diego v. Murphy, No. GIC 854373 (Cal. Super. Ct. Sept. 23, 2005); Complaint, City of San Diego v. Murphy, No. GIC 854373 (Cal. Super. Ct. Jan. 3, 2006). Nevertheless, in another lawsuit brought by City Attorney Aguirre and the City against SDCERS, the City moved for summary judgment for, among other things, a declaration that the retirement benefits created under LORP and EORP violated Section 1090, the City Charter, and the California Constitution. The City's motion was denied on technical grounds. Some City officials have moved to disqualify the City Attorney from this case because they allege that City Council never gave the City Attorney permission to file it on the City's behalf. Defendants and Cross-complainants San Diego City Attorney Michael J. Aguirre and the City of San Diego's Memorandum of Points and Authorities in Support of Motion For Summary Judgment, or in the Alternative, Summary Adjudication of the Issues, Councilmember Peters and Former Mayor Murphy's Memorandum of Points and Authorities in Support of Motion to Disqualify the City Attorney, To Quash Subpoenas and for a Protective Order, San Diego Employees' Ret. Sys. v. Aguirre, No. GIC 841845, at 8-27 (Cal. Super. Ct. Apr. 24, 2006).

- Presidential Retirement Agreement Between the City of San Diego and Ron Saathoff, President of the San Diego City Firefighters, Local 145 (Dec. 12, 2003); Letter from Rick A. Roeder to Larry Grissom, Retirement Administrator (Nov. 5, 2002); Letter from Constance M. Hiatt and Robert Blum to Lawrence Grissom, Retirement Administrator (Draft June 12, 2002); E-mail from Terri Webster to Dan Kelley (May 21, 2002); E-mail from Terri Webster to Ed Ryan, Mary Vattimo and Cathy Lexin cc to Bruce Herring (Feb. 28, 2002); Interview by the Audit Committee with Richard Vortmann (May 1, 2006).
- The Deferred Retirement Option Program, or "DROP," allows an employee to begin receiving his or her pension payments, which are invested in a separate interest-earning account, while he or she continues to work for up to five years for the City. Once the employee retires, he or she may take a one-time payout or have the money invested in an annuity for incremental distribution. Jennifer Vigil, *Deputy City Manager Herring Will Retire*, Aug. 5, 2005, San Diego Union-Tribune, available at http://www.signonsandiego.com/news/metro/pension/20050805-9999-7m5herring.html.
- This is not the only unique benefit of which Mr. Saathoff took advantage. In the spring of 2002, Mr. Saathoff requested three and one-half years of service credit under the PSC program. Despite 18 months passing since Mr. Saathoff's initial request was priced in 2000, SDCERS Administrator Lawrence Grissom permitted him to make the purchase in 2002 at 2000 prices a savings of about \$9,900 without the knowledge of the SDCERS Board. By this time, Mr. Saathoff was well aware that PSCs were underpriced and increased the System's unfunded liability. Mr. Saathoff was also aware that the Presidential Leave benefit was part of the ongoing meet and confer negotiations and would enable him to use both his City and union salaries to calculate his retirement benefits, even though his union salary was not included in calculating the price of his service credits. Audit Report from Darlene Morrow-Truver, Audit Manager, to Richard Vortmann, Chair, Audit Committee, SDCERS (Feb. 27, 2004); Draft Memorandum from Darlene Morrow-Truver, Audit Manager, to Loraine E. Chapin, General Counsel (Oct. 24, 2003); Letter from Rick A. Roeder to Service Purchase Task Force (Feb. 19, 2002).

The Presidential Leave package was passed by resolution just weeks before the City Council approved the ordinance implementing MP-2, 620 and before the SDCERS Board (including Mr. Saathoff himself) gave its final approval to modify the City's contribution rate. The resolution allowed Mr. Saathoff and (in theory) others to combine their City and union salaries to calculate the high one-year salary for purposes of calculating their pension benefits. 621 Although the MP-2 ordinance was first introduced on the same day the Presidential Leave resolution was adopted, conspicuously, Presidential Leave was addressed separately than MP-2 and by a different vehicle, a resolution. 622 By approving the benefit by resolution (rather than ordinance) the City Council did not need to consider it twice as it otherwise would have (guaranteeing Mr. Saathoff his benefit well in advance of when his Board vote on MP-2 took place), and the benefit was implemented without a vote by the SDCERS membership. 623 The timing and manner in which Mr. Saathoff received this benefit further suggests a level of intentional and willful misconduct by Mr. Saathoff surpassing that of the other non-City representatives on the Board. 624 In participating in the shaping of MP-2 while simultaneously benefiting substantially from its approval, Mr. Saathoff acted with wrongful intent.

San Diego City Council Resolution 297212 (Oct. 21, 2002); San Diego, Cal., Ordinance O-19121 (Nov. 18, 2002). Moreover, this resolution was passed before Mr. Saathoff and the SDCERS Board gave their final approval of the City contribution agreement aspect of MP-2. Minutes, SDCERS Board Meeting at 29-30 (Nov. 15, 2002).

San Diego City Council Resolution 297212 (Oct. 21, 2002). In practice, this resolution only benefited Mr. Saathoff, as he was the only union president who actually received a City salary in addition to his union salary. Email from Judy Zellers to Lawrence Grissom cc to Cathy Lexin and Terri Webster (Sept. 20, 2001).

Minutes, San Diego City Council Meeting at 9-11, 30-31 (Oct. 21, 2002).

The San Diego City Charter requires that most types of ordinances (including the MP-2 ordinance at issue) must be introduced at a Council meeting at least twelve days before they are ultimately approved by Council and must be read in full prior to final passage. San Diego City Charter art. III, § 16. Resolutions, on the other hand, take effect upon passage unless otherwise stated within the resolution. San Diego City Charter art. III, § 17. The Charter also mandates that any ordinance which affects the benefits of any employee or retiree must be approved by a majority vote of the members of SDCERS. San Diego City Charter art. IX, § 143.1. As stated in the MP-2 ordinance and noted at the meeting at which it was introduced, the ordinance could only take effect "upon approval by the Membership of the Retirement System pursuant to Charter Section 143.1." San Diego, Cal., Ordinance O-19121 (Nov. 18, 2002); Minutes, San Diego City Council Meeting at 10 (Oct. 21, 2002).

While the Reish Luftman Report refrained from discussing conflict of interest violations, it concluded that Ron Saathoff and Terri Webster breached their fiduciary duties as SDCERS Board members by not informing the other Board members about the benefit enhancements they were receiving through MP-2. Reish Luftman Reicher & Cohen, Legal Analysis of Investigative Report on the San Diego City Employees' Retirement System at 93-94 (Jan. 20, 2006). The City Attorney concluded that Mr. Saathoff (among other City employees on the SDCERS Board) violated conflict of interest provisions and breached his fiduciary duties to SDCERS by approving MP-2. City Attorney Michael J. Aguirre, Interim Report No. 3 Regarding Violations of State and Local Laws as Related to the SDCERS Pension Fund at 14-21 (Apr. 9, 2005). Vinson & Elkins only suggested that Mr. Saathoff and other City employee members of the SDCERS Board may have been induced to approve MP-2 through enhanced benefits and, in doing so, also violated conflict of interest provisions. Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 60-62, 70-73 (Draft July 15, 2005).

Finally, responsibility for these illegal conflicts must be allocated to the SDCERS Board itself which – apart from the failings of any individual Board member – was plagued by a pervasive lack of structural independence from the City. With three of its 13 members representing the City Manager, Auditor, and Treasurer, and with an additional six chosen from a combination of union representatives, City employees, and retirees – each of whom receives benefits from the system – it was inevitable the City would wield undue influence over the deliberations of the SDCERS Board, especially where enhanced member benefits were at stake. Where MP-1 and MP-2 were concerned, the interests of the City in avoiding its payment obligations to SDCERS appear to have taken precedence in the Board's deliberations, to the detriment of the one entity they were duty-bound to protect – the SDCERS Trust.

2. SDCERS Administrator Lawrence Grissom

If any one person could be said to have "run" SDCERS, that person was Lawrence Grissom. Mr. Grissom was the SDCERS Administrator, a position he had held for many years, and he understood and appreciated the actuarial underpinnings of SDCERS better than anyone else. Based on his professional background, experience, and responsibilities, Mr. Grissom could have and should have prevented many of the actions taken by the Board that breached the Board's fiduciary duty or posed an unacceptable risk to the health of SDCERS. Mr. Grissom failed to fulfill his professional obligations to the plan participants whose retirement security he was entrusted to administer.

San Diego City Charter art. IX, § 144 (amended Nov. 2, 2004); San Diego City Charter art. X, § 1 (amended Nov. 2, 2004). As of April, 1, 2005, the composition of the Board changed to include seven independent members and six members required to be chosen from a combination of union representatives, City employees (including one City Manager Designee), and retirees. San Diego City Charter art. IX, § 144.

Minutes, SDCERS Board Meeting at 1, 7 (May 20, 2005); Memorandum from Lawrence B. Grissom, Retirement Administrator, to Bruce Herring, Deputy City Manager (July 1, 2002); Memorandum from Lawrence B. Grissom, Retirement Administrator, to Retirement Board, via Business Procedures Committee (Mar. 6, 2001); Memorandum from Lawrence B. Grissom, Administrator, to Retirement Board (June 18, 1996); Memorandum from Lawrence B. Grissom, Administrator, to Retirement Board of Administration (June 12, 1996); Minutes, SDCERS Board Meeting at 1, 31 (May 19, 1995).

The City Attorney alleged that Mr. Grissom violated fiduciary duties owed to the SDCERS members by participating in and influencing the decisions to implement MP-1 and MP-2 because he received special compensation not given to others in his position. Second Amended Complaint, People v. Grissom, No. GIC 850246, at 11-12 (Cal. Super. Ct. Dec. 12, 2005). However, in a related action, the court held that Mr. Grissom could only be liable for conspiring to breach a Board member's fiduciary duty, since art. 15, § 17 establishes a fiduciary relationship between Board members and beneficiaries only, not SDCERS employees and beneficiaries. Order, San Diego City Employees' Ret. Sys. v. Aguirre, No. GIC 841845, at 9 (Cal. Super. Ct. Sept. 26, 2005). Notably, in Interim Report No. 6 issued earlier in 2005, the City Attorney had concluded that Mr. Grissom did owe a fiduciary duty to SDCERS members and violated that duty by allowing the City to stray from its actuarially calculated contributions to the plan, though the City Attorney did not provide a legal basis for a pension plan administrator's fiduciary relationship to plan participants. City Attorney Michael J. Aguirre, Amended Interim Report No. 6 Regarding the San Diego City Employees' Retirement System Funding Scheme at 33 (July 1, 2005). The legal analysis accompanying the Navigant Report discussed the possibility that Mr. Grissom owed an affirmative duty under California employment law to voice concerns about potential wrongdoing of the Board, but largely concluded that such a duty does not exist. Reish Luftman Reicher & Cohen, Legal Analysis of Investigative Report on the San Diego City Employees' Retirement System at 119 (Jan. 20, 2006).

With respect to MP-1, it was Mr. Grissom who served as the "client" in dealings with the Board's advisors, including its actuary and fiduciary counsel. ⁶²⁸ Insofar as the Board failed to seek appropriate legal advice, or acted on poorly understood actuarial recommendations, Mr. Grissom bears responsibility for failing to supervise properly the Board's professional advisors. Moreover, among the Board's professional staff, Mr. Grissom best understood that the concept of Surplus Earnings, the linchpin of MP-1, was premised upon a fundamental misconception. ⁶²⁹ Mr. Grissom knew SDCERS's earnings in excess of 8% were not truly "surplus" because SDCERS needed to keep those assets within the system to make up for years in which investment returns fell short of the actuarially determined 8% return. ⁶³⁰ Notwithstanding this knowledge, Mr. Grissom facilitated the Board's decision to adopt MP-1, putting, as the Board did, the City's interest in avoiding actuarially determined contributions over and above the interests of SDCERS. If anyone should have kept the Board "honest" with respect to MP-1, it was Mr. Grissom. He failed in this responsibility.

Worse yet, after MP-1 had been approved, Mr. Grissom adopted the City's goal of limiting disclosure about the extent of the underfunding that MP-1 created. The City resisted reporting any NPO at all, based on the fundamentally flawed argument that the NPO was "funded in a reserve." Mr. Grissom not only supported this position himself, he went so far as to suggest that SDCERS consider changing actuaries because Mr. Roeder was resistant to the argument that there was no need to report an NPO. When the City did finally report an NPO (reduced by the adoption of a 40-year amortization period), Mr. Grissom helped craft the misleading disclosure that the NPO was "funded in a reserve." To the extent that Mr. Grissom supported the City's failure to report, and then its under-reporting of, the NPO, he facilitated the City's violation of its disclosure obligations to the public and SDCERS's fiduciary obligations to its members.

Mr. Grissom's actions were even more egregious when it came to MP-2. There, Mr. Grissom did not even believe the proposal was in the best interests of SDCERS. In fact, as he later admitted

City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal); Memorandum from Lawrence B. Grissom, Administrator, to Retirement Board (June 18, 1996); Memorandum from Lawrence B. Grissom, Administrator, to Retirement Board of Administration (June 12, 1996).

Letter from Dwight Alan Hamilton, Hamilton and Faatz, and John A. Graham, Frandzel & Share, to Lawrence B. Grissom, Retirement Administrator (June 21, 1996); Letter from Rick A. Roeder to Larry Grissom (June 13, 1996).

Minutes, SDCERS Investment Committee Meeting at 16 (Apr. 18, 2002) (Grissom states the term "surplus earnings" is a misnomer); Minutes, SDCERS Investment Committee Meeting at 4 (Mar. 20, 1997) (Grissom states that surplus is not considered excess earnings until the System's funding ratio exceeds 100%).

E-mail from Terri Webster to Lawrence Grissom (July 9, 1999); E-mail from Lawrence Grissom to Terri Webster (Mar. 31, 1998).

E-mail from Rick Roeder to Lawrence Grissom and Paul Barnett (Sept. 5, 2003); E-mail from Lawrence Grissom to Terri Webster (Mar. 31, 1998).

to SDCERS's outside counsel, he affirmatively believed that there was "very little justification" for it. 633 Notwithstanding his reservations, Mr. Grissom shepherded the proposal through the Board's deliberative process in a heavy-handed manner that all but guaranteed its adoption. He directed SDCERS's fiduciary counsel, Robert Blum, as to how Mr. Blum's supposedly independent legal advice should come out (at first requesting an opinion disapproving MP-2 and, later, asking Mr. Blum to reverse course and approve the measure). 634 He encouraged Mr. Blum to twist the actuary's arm when Mr. Roeder began having second thoughts about releasing a written opinion advising that the five-year phase-in adopted by MP-2 was "reasonable," resulting in an actuary opinion that was confusing if not affirmatively misleading. 635 And he instructed Mr. Roeder to cease having "one-on-one" conversations with Board members, after Mr. Roeder had responded to Diann Shipione's inquiries by sharing his concerns about MP-2 with her. 636 In actively manipulating the independent assessments of the outside professionals who were charged with providing objective advice about the health of the pension system, Mr. Grissom failed in his responsibility to administer and protect the SDCERS Trust. In so doing, Mr. Grissom acted with wrongful intent.

3. SDCERS General Counsel's Office

In 1997, Loraine Chapin began service as SDCERS General Counsel, filling a role that had previously been handled by the City Attorney's Office. Unlike SDCERS Administrator Lawrence Grissom, Ms. Chapin does not appear to have played an active role in shaping and winning approval for MP-1, MP-2 or in any of the disclosure issues arising out of the proposals. Nonetheless, Ms. Chapin failed to adequately perform the critical legal watchdog role assigned to her.

With respect to MP-2 (since Ms. Chapin assumed her position within SDCERS after the adoption of MP-1), the record shows that Ms. Chapin was fully informed of all developments concerning the

E-mail from Lawrence Grissom to Sheila Leone cc to Loraine Chapin, Paul Barnett, and Sheila Jacobs (Sept. 12, 2003). Moreover, Mr. Grissom appears to have understood the potential illegality of City officials on the SDCERS Board having a hand in crafting their own benefits. E-mail from Terri Webster to Lawrence Grissom (May 20, 2002).

E-mail from Sheila Leone to Loraine Chapin cc to Roxanne Story Parks (Mar. 24, 2003).

Letter from Rick A. Roeder to Larry Grissom, Retirement Administrator (Nov. 5, 2002); E-mail from Lawrence Grissom to Robert Blum (Oct. 30, 2002).

See E-mail from Rick Roeder to Lawrence Grissom (Nov. 26, 2002); E-mail from Constance Hiatt to Lawrence Grissom (July 18, 2002).

Ms. Chapin had previously counseled the SDCERS Board as a Deputy City Attorney until the official position of SDCERS General Counsel was created within SDCERS in 1997. Agreement for Retirement System Legal Services (Apr. 9, 1997). In her capacity as a Deputy City Attorney, she attended the June 11, 1996, SDCERS Board meeting at which MP-1 was proposed. The minutes reflect her explaining that, based on "her review of this proposal, the only amendment she is aware of that would need to occur would be a City Charter amendment in regards to the health insurance issue." Minutes, SDCERS Board Meeting at 8 (June 11, 1996). From the evidence available to the investigation, it does not appear that Ms. Chapin raised any other concerns about the legality of MP-1.

proposal and its approval by SDCERS. First, in her capacity as SDCERS General Counsel, Ms. Chapin was present at the SDCERS Board meeting at which MP-2 was first formally proposed and the two subsequent meetings at which it was discussed and approved. Second, Ms. Chapin appreciated the inherent legal problems with simultaneously granting new benefits to SDCERS members and providing contribution relief to the City. In dealing with the task of modifying the Municipal Code to allow for assets in the Employee Contribution Rate reserve to be used to offset benefit increases, Ms. Chapin stated: "This is further support for the propositions that future meet and confer benefits involving retirement not be subject to a contingency such as the Board approving requested funding changes for the System as well as prospective effective dates." Third, Ms. Chapin understood the potential for allegations of fiduciary duty breaches by SDCERS Board members, as she worked with SDCERS fiduciary counsel to address the desire of several Board members to secure indemnification by the City in connection with the approval of MP-2. On the countribution of the countribution was supported to address the desire of several Board members to secure indemnification by the City in connection with the approval of MP-2.

Moreover, Ms. Chapin failed to timely address the conflicts of interest that colored the votes of various SDCERS Board members, most prominently Cathy Lexin, who only recused herself from consideration of the proposal *after* the critical vote approving MP-2 at the July 11, 2002 SDCERS Board meeting. 642 Ms. Chapin's failure to address this issue before the July 11, 2002 meeting is particularly glaring

E-mail from Robert Blum to Loraine Chapin, Lawrence Grissom and Paul Barnett cc to Constance Hiatt (Oct. 23, 2002); E-mail from Daniel Kelley to Loraine Chapin cc to Lawrence Grissom, Paul Barnett, Roxanne Parks, Michael Rivo and Cathy Lexin (Aug. 22, 2002); E-mail from Loraine Chapin to Leslie Girard cc to Lawrence Grissom, Paul Barnett and Roxanne Parks (Aug. 21, 2002); E-mail from Loraine Chapin to Robert Blum cc to Lawrence Grissom, Paul Barnett, Roxanne Story Parks and Sheila Leone (Aug. 21, 2002); E-mail from Robert Blum to Lawrence Grissom, Paul Barnett and Loraine Chapin cc to Constance M. Hiatt and Marcus Wu (July 30, 2002); E-mail from Lawrence Grissom to Loraine Chapin, Roxanne Story Parks and Constance Hiatt cc to Paul Barnett and Robert Blum (June 26, 2002).

Minutes, SDCERS Board Meeting at 1 (June 21, 2002); Minutes, SDCERS Board Meeting at 1 (July 11, 2002); Minutes, SDCERS Board Meeting at 1 (Nov. 15, 2002).

E-mail from Loraine Chapin to Leslie Girard cc to Lawrence Grissom, Paul Barnett and Roxanne Parks (Aug. 21, 2002). See also e-mail from Loraine Chapin to Terri Webster (Oct. 10, 2002) (Chapin states that "this underscores my frustration with the meet and confer process this year as it relates to retirement benefits. It has been a nightmare.").

E-mail from Robert Blum to Loraine Chapin, Lawrence Grissom and Paul Barnett cc to Constance Hiatt (July 15, 2002); E-mail from Lawrence Grissom to Loraine Chapin, Roxanne Story Parks, and Constance Hiatt cc to Paul Barnett and Robert Blum (June 26, 2002).

It appears that Ms. Chapin only became sensitive to this conflict of interest issue after SDCERS fiduciary counsel indicated that Ms. Lexin's position as both negotiator for the City and fiduciary for SDCERS members might implicate legal concerns. E-mail from Robert Blum to Lawrence Grissom, Paul Barnett and Loraine Chapin cc to Constance Hiatt and Marcus Wu (July 30, 2002); E-mail from Loraine Chapin to Robert Blum cc to Lawrence Grissom, Paul Barnett, Roxanne Story Parks and Sheila Leone (Aug. 21, 2002).

This was not the only occasion upon which Ms. Chapin overlooked potential conflict of interest issues. In connection with the 2003 audit of Ron Saathoff's Presidential Leave benefit, the Audit Division of the Auditor and Comptroller's Office investigated an administrative glitch that had allowed Mr. Saathoff to purchase service credit in July 2002 at a discounted contract price. Mr. Saathoff had originally filed an application to purchase four years in

considering she had previously authored an opinion while working under former City Attorney John Witt discussing the fiduciary implications of a SDCERS Board member taking an active role in the meet and confer process.⁶⁴³

On the issues of evaluating the legality of MP-2 and the fiduciary obligations of the SDCERS Board, the performance of other legal staff members of SDCERS – in particular, Assistant General Counsel Roxanne Story Parks – was similarly deficient. Ms. Parks attended each of the critical SDCERS Board meetings at which MP-2 was discussed and approved. Ms. Parks worked hand-in-hand with Ms. Chapin in drafting the ordinance underlying certain aspects of MP-2 and in working with fiduciary counsel to implement the request of several SDCERS Board members that the Board be indemnified by the City in connection with its approval of MP-2 on November 15, 2002. While Assistant General Counsel Sheila Leone Jacobs served a similar role as Ms. Parks, it appears from the evidence available that she did not have as active a role as Ms. Parks in drafting the MP-2 ordinance and considering legal issues implicated by MP-2.

2000, but the contract was apparently never processed and delivered to him. Though Mr. Saathoff did not follow up on this error for nearly two years, SDCERS staff allowed him to use the contract price from his original application in 2000 when he reapplied to purchase credit in 2002. E-mail from Paul Barnett to Alex Ruiz, Darlene Morrow-Truver, and Judy Zellers (Oct. 21, 2003). The Audit Division sought to present this matter to the SDCERS Board, bypassing the staff because of the possible conflict of interest surrounding the favorable treatment accorded Mr. Saathoff. Ms. Chapin resisted the efforts of the Audit Division, believing that it was not necessary to modify Mr. Saathoff's purchase contract or bring the matter before the SDCERS Board. Draft Confidential Audit Memo from Darlene Morrow-Truver, Audit Manager, to Loraine E. Chapin, General Counsel (Oct. 24, 2003); E-mail from Judy Zellers to Darlene Morrow-Truver and Kyle Elser (Oct. 21, 2003); Interview by the Audit Committee with Darlene Morrow-Truver (Apr. 26, 2006).

- Memorandum of Law from City Attorney to Larry B. Grissom, Retirement Administrator (Mar. 10, 1992) (authored by Loraine L. Etherington (Chapin), Deputy City Attorney). In Ms. Chapin's defense, Mr. Blum (SDCERS fiduciary counsel) had weighed in on the issue of SDCERS Board members' conflicts of interest in early July 2002, reasoning that a SDCERS Board member (Tom Rhodes, president of and labor negotiator for the Police Officer's Association) who was involved in the labor negotiations earlier in the year could discharge his fiduciary duties in voting on MP-2 so long as "he/she can vote as a fiduciary and act separately from the role as a negotiator, and actually does this." E-mail from Robert Blum to [Tom Rhodes] cc to Connie M. Hiatt, Loraine Chapin, Lawrence Grissom and Paul Barnett (July 3, 2002). However, as illustrated by Mr. Blum's change of course later in July 2002, Cathy Lexin's involvement in the approval of MP-2 presented a much more substantial conflict that that of Mr. Rhodes, who was not involved in the crafting of the MP-2 agreement as a whole. Similar to Mr. Blum, Ms. Chapin should have been more sensitive to the conflicts surrounding Ms. Lexin before the July 11, 2002 SDCERS Board meeting.
- Besides Ms. Chapin and Ms. Parks, SDCERS internal legal staff consisted only of Assistant General Counsel Sheila Leone Jacobs and several paralegals. Interview by Navigant Consulting with Roxanne Story Parks (Dec. 15, 2005). Ms. Parks and Ms. Leone currently work in the Office of SDCERS General Counsel.
- Minutes, SDCERS Board Meeting at 1 (June 21, 2002); Minutes, SDCERS Board Meeting at 1 (July 11, 2002); Minutes, SDCERS Board Meeting at 1 (Nov. 15, 2002). Ms. Jacobs attended the June 21, 2002 and November 15, 2002 meetings.
- E-mail from Loraine Chapin to Terri Webster (Oct. 10, 2002); E-mail from Loraine Chapin to Robert Blum cc to Lawrence Grissom, Paul Barnett, Roxanne Story Parks and Sheila Leone (Aug. 21, 2002); E-mail from Loraine Chapin to Leslie Girard cc to Lawrence Grissom, Paul Barnett and Roxanne Parks (Aug. 21, 2002); E-mail from Lawrence Grissom to Loraine Chapin, Roxanne Story Parks and Constance Hiatt cc to Paul Barnett and Robert Blum (June 26, 2002).

The Audit Committee requested to speak with Ms. Chapin, Ms. Parks, and Ms. Jacobs about, among other things, the operations of the Office of General Counsel. All three declined to be interviewed.

Apparently, due to conflict of interest concerns (since SDCERS staff members would be affected by the benefit enhancements), Ms. Chapin instructed Ms. Parks and Ms. Jacobs to defer to outside fiduciary counsel in rendering legal advice to the Board in connection with MP-2. Surprisingly, they were not alarmed after the remarkable turnaround in fiduciary counsel Hanson Bridgett's advice, first cautioning the Board against approving MP-2 and then changing course and issuing an opinion in November 2002 endorsing the proposal as a "reasonable exercise of the Board's fiduciary responsibilities." Significantly, Ms. Chapin appears to have been involved in the shaping of Hanson Bridgett's second opinion letter in 2002, discussions with the City over certain aspects of MP-2, and was privy to information suggesting that pressure was put on SDCERS actuary Rick Roeder to approve the modified funding mechanism of MP-2. Though Ms. Chapin may have formally refrained from advising the SDCERS Board as to their fiduciary obligations, she was very much involved in the selling of the proposal to the Board.

Given her participation in the crafting of MP-2 and her awareness of the significant fiduciary issues it raised, Ms. Chapin failed to fulfill her legal duties to SDCERS. To the extent of their respective awareness of the fiduciary concerns surrounding MP-2, Ms. Parks and Ms. Jacobs must also bear some responsibility for failing to act on warning signs of significant legal problems with the proposal.

4. SDCERS Actuary Rick Roeder

Rick Roeder, of Gabriel, Roeder, Smith & Company, was the SDCERS actuary throughout MP-1 and MP-2. When confronted with important decisions, the Board looked to Mr. Roeder for actuarial advice.

Mr. Roeder bears substantial responsibility for the Board's decision to adopt MP-1. Of all of the Board's advisors, Mr. Roeder was the most qualified to understand, and explain to the Board, the basic conceptual mistake supporting the Board's assumption that SDCERS's Surplus Earnings were assets the

Interview by Navigant Consulting with Roxanne Story Parks (Dec. 15, 2005).

E-mail from Sheila Leone to Lori Chapin cc to R. Parks (Mar. 24, 2003); Letter from Bob Blum and Connie Hiatt to Frederick Pierce, Retirement Board President (Nov. 18. 2002); Letter from Constance M. Hiatt and Robert Blum to Lawrence Grissom, Retirement Administrator (Draft June 12, 2002). Correspondence between Ms. Parks and Ms. Jacobs regarding the deposition of Robert Blum arising out of SDCERS's lawsuit against Hanson Bridgett for professional malpractice suggests that Ms. Parks and Ms. Jacobs were, at the very least, aware of Mr. Blum's reversal of opinion in 2002. E-mail from Sheila Jacobs to Roxanne Story Parks (Jan 30, 2004); E-mail from Sheila Jacobs to Reg Vitek (Jan. 29, 2004); Interview by Navigant Consulting with Roxanne Story Parks (Dec. 15, 2005).

E-mail from Robert Blum to Rick Roeder cc to Constance Hiatt, Loraine Chapin, Lawrence Grissom and Paul Barnett (Oct. 29, 2002); E-mail from Lawrence Grissom to Loraine Chapin (Oct. 24, 2002); E-mail from Robert Blum to Lawrence Grissom, Paul Barnett and Loraine Chapin cc to Connie M. Hiatt (Sept. 22, 2002); E-mail from Robert Blum to Loraine Chapin, Lawrence Grissom and Paul Barnett (Sept. 16, 2002).

Board could deplete for any reason it saw fit. However, it does not appear Mr. Roeder properly advised the Board regarding the erroneous assumption at the very foundation of the Surplus Earnings concept, nor did he advise the Board of the fact that, in adopting MP-1, it was putting the soundness of SDCERS at grave risk. Instead, Mr. Roeder fell in line with Mr. Grissom and City representatives on the Board, basing his support on the inclusion of the trigger provision in the proposal. 650

Mr. Roeder also failed to render competent, clear actuarial advice in connection with MP-2. Unlike MP-1, however, which Mr. Roeder believed could work as long as the City respected the funded ratio "trigger," Mr. Roeder never believed MP-2 was in the best interests of SDCERS. Notwithstanding this belief, Mr. Roeder allowed himself to be marginalized by SDCERS's fiduciary counsel, Robert Blum, and others who were advocating for MP-2. For example, in response to doubts raised by Mr. Roeder over language in his "final" actuarial opinion suggesting that he endorsed MP-2, Mr. Blum cautioned Mr. Roeder that "lots of people would be very unhappy if you are unwilling to sign off on it [the November 5, 2002 actuarial letter] now." After Mr. Roeder backed down, Mr. Blum forwarded the entire e-mail chain

At the June 11, 1996 SDCERS Board meeting at which MP-1 was proposed, the minutes reflect that Mr. Roeder explained that "he would have been reluctant to recommend this plan without some sunset provisions. However, he stated that he believes that this is a sound proposal as long as the funded ratio does not drop significantly, and with the appropriate sunset provisions in place." Minutes, SDCERS' Retirement Board of Administration Special Workshop at 15 (June 11, 1996).

In an action brought by the City Attorney against Gabriel, Roeder, Smith & Co. ("GRS"), among other entities, it is alleged that GRS, but not Mr. Roeder specifically, committed professional negligence by endorsing MP-1 and continually representing that SDCERS was in good financial health between 1997 and 2001. Although the City also claimed that GRS had committed intentional fraud and affirmative misrepresentation and intentional fraud and concealment, it did not allege that Mr. Roeder (or GRS) committed professional malpractice or breached fiduciary duties owed to SDCERS. First Amended Complaint at 11, City v. Callan Associates, Inc., No. GIC 852419 (Cal. Super. Ct. Aug. 15, 2005).

Letter from Rick Roeder to Councilman Scott Peters (Aug. 12, 2004); Letter from Reg A. Vitek, Seltzer Caplan McMahon Vitek, to Sheila Leone, Esq., San Diego City Employees' Retirement System cc to Michael A. Leone, Esq. (Mar. 5, 2003); Letter from Rick A. Roeder to Larry Grissom, Retirement Administrator (Nov. 5, 2002); E-mail from Constance Hiatt to Lawrence Grissom cc to Robert Blum (July 18, 2002); Presentation, "Analysis of Proposed Change to Manager's Proposal" (July 11, 2002) (For Mr. Roeder to be satisfied "that the updated manager's Proposal is financially viable, the City would need to demonstrate that a significantly higher amount of financial resources will be available to be allocated to pension funding and will, in fact, be made."); Presentation, "Actuarial Information re: Manager's Proposal" (June 12, 2002); Minutes, SDCERS' Retirement Board of Administration Special Workshop at 15 (June 11, 1996).

In the months leading up to MP-2, Mr. Blum, Ms. Chapin, and Mr. Grissom, among others, compromised Mr. Roeder's independence by, at the very least, seeking to shape the contours of Mr. Roeder's opinion to meet the demands of the Board and the proposal. E-mail from Robert Blum to Loraine Chapin, Lawrence Grissom, and Paul Barnett cc to Constance Hiatt (Sept. 16, 2002) ("[I] now have a good first draft of the opinion letter in connie's hands. the key will be what we can get rick to say.").

E-mail from Lawrence Grissom to Robert Blum (Oct. 30, 2002). Later, in connection with Mr. Blum's November 18, 2002, fiduciary opinion to the SDCERS Board, Mr. Blum vetoed a sentence that Mr. Roeder wanted to include in the opinion warning that MP-2 could result in twelve consecutive years of paying less than the actuarial rate. E-mail from Rick Roeder to Richard C. Sauer (June 21, 2004).

reflecting their communications to Mr. Grissom, noting that "rick will sign," to which Mr. Grissom replied, "good." The exchange is illuminating in that it shows how Mr. Roeder, apparently against his better judgment, was effectively pressured into providing to the SDCERS Board the paper trail it needed to justify MP-2. 655 Mr. Roeder's inability to stand up to this pressure is a large part of the reason that SDCERS finds itself in the current financial crisis. The Audit Committee requested to speak with Mr. Roeder regarding, among other things, his working relationship with SDCERS fiduciary counsel and his actuarial opinions. Mr. Roeder declined to be interviewed.

Finally, by repeatedly issuing annual valuation reports blessing SDCERS as actuarially "sound" – even after the City had adopted a funding program that was, by his own estimation, guaranteed to erode the actuarial soundness of SDCERS – Mr. Roeder facilitated the perpetuation of the underfunding scheme and breached his professional obligations to the SDCERS Trust. Time and time again, Mr. Roeder

E-mail from Lawrence Grissom to Robert Blum (Oct. 30, 2002). Nonetheless, Mr. Roeder's final opinion, while tepid in its endorsement of MP-2 – noting only that the version as adopted was "reasonable" as compared with what had come before – affirmatively stated that it would be preferable for the Board to leave MP-1 in place. Letter from Rick A. Roeder to Larry Grissom, Retirement Board Administrator (Nov. 5, 2002); Letter from Reg A. Vitek, Seltzer Caplan McMahon Vitek, to Sheila Leone, Esq., SDCERS, cc to Michael A. Leone, Esq. (Mar. 5, 2003).

In a lawsuit brought by three individual members of SDCERS against Mr. Roeder and his actuarial firm, Gabriel, Roeder, Smith & Company ("GRS"), the plaintiffs alleged that Mr. Roeder and GRS committed fraud by concealment and negligence by concealing or failing to disclose that MP-2 would render the City's pension fund actuarially unsound. Complaint, Gleason v. Gabriel, Roeder, Smith & Co., No. GIC 849882, at 3 (Cal. Super. Ct. June 28, 2005). In a partial dismissal, the allegations against Mr. Roeder, individually, were dismissed without prejudice by the Court. Dismissal Entered on March 7, 2006, Gleason v. Gabriel, Roeder, Smith & Co., No. GIC 849882 (Cal. Super. Ct. Mar. 7, 2006).

Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2001, at 17 (Feb. 12, 2002); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2000, at 19 (Mar. 8, 2001); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1999, at 17 (Feb. 14, 2000); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1998, at 18 (May 5, 1999); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1997, at 17 (Jan. 16, 1998); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1996, at 19 (Jan. 9, 1997); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1995, at 16 (Jan. 19, 1996)

Minutes, SDCERS Board Meeting at 16 (June 11, 1996) (Mr. Roeder stated that under the Proposal "some of these costs will be borne by the future generation.").

The Actuarial Standards Board Code of Professional Conduct requires an actuary to perform his duties with integrity, competence, skill, and care. Actuarial Standards Board, Code of Prof l Conduct, Precept 1, Annotation 1-1 (2001). Additionally, actuaries must take reasonable steps to ensure that their services are not used to mislead others. Actuarial Standards Board, Code of Prof l Conduct, Precept 8 (2001). The actuary must present information in a manner that is clear, because of the risk that misinterpretations may influence the actions of third parties. Actuarial Standards Board, Code of Prof l Conduct, Precept 8, Annotation 8-1 (2001).

failed to provide the objective, critical advice that could have protected the SDCERS Trust from the City's penchant for seeking to minimize its contributions to the System. 659

5. SDCERS's Fiduciary Counsel

In connection with MP-1 and MP-2, the Board received advice from its fiduciary counsel that, ultimately, sanctioned both proposals. 660 Both times, the Board was poorly served by its counsel.

Fiduciary counsel Dwight Hamilton of the law firm Hamilton and Faatz at first opposed MP-1, raising a number of "red flags" and opining that an agreement to freeze contribution rates would breach the Board's fiduciary duty by tying its hands when changes in actuarial assumptions and financial circumstances otherwise demanded an increase in the City's contribution rates. In particular, Mr. Hamilton was concerned that the SDCERS actuary would not be permitted to alter the actuarial assumptions underlying the System until, at the earliest, 2007. Mr. Hamilton later changed his opinion after MP-1 was modified to allow, among other things, the actuary to annually review and change actuarial assumptions that, in turn, could require the City to increase its contribution schedule such that the City's annual contribution would reach the full EAN rate by July 1, 2009. Notably, this revision did not correct the fundamental flaw first perceived by Mr. Hamilton – the City would be allowed to make annual contributions to the System at a rate lower than that calculated by the actuary. Even in signing off on MP-1, Mr. Hamilton's opinion was carefully worded to note merely that the Board would be acting within its "discretion" under the California

With regard to MP-1, the City Attorney reached a similar conclusion: "Mr. Roeder's conduct fell below applicable professional standards, for in providing guidance to the pension board on explaining the actuarial affect [sic] of MP-1 to plan participants and board members, he was acting as a plan fiduciary." City Attorney Michael J. Aguirre, Interim Report No. 6 Regarding the San Diego City Employees' Retirement System Funding Scheme at 34 (June 21, 2005). With regard to Roeder being pressured into approving MP-2, the City Attorney's conclusion was generally consistent with that of the Audit Committee. City Attorney Michael J. Aguirre, Interim Report No. 7 SDCERS Attorney-Client Privilege Documents Released Under Federal Court Order at 9-13 (Dec. 6, 2005). The Reish Luftman Report suggested that Mr. Roeder did not fulfill his duties as SDCERS actuary by definitively warning the Board of the problems with MP-1 and MP-2. Reish Luftman Reicher & Cohen, Legal Analysis of Investigative Report on the San Diego City Employees' Retirement System at 75, 89-90 (Jan. 20, 2006).

Letter from Bob Blum and Connie Hiatt to Frederick W. Pierce, IV, President, Retirement Board (Nov. 18, 2002); Letter from Dwight Alan Hamilton, Hamilton and Faatz, and John A. Graham, Frandzel & Share, to Lawrence Grissom, Retirement Administrator (June 21, 1996).

Minutes, SDCERS' Retirement Board of Administration Special Workshop at 18-21 (June 11, 1996).

Minutes, SDCERS' Retirement Board of Administration Special Workshop at 20 (June 11, 1996). The first iteration of MP-1 provided only an "extraordinary circumstances" exception to this constraint on the SDCERS Board's ability to modify the actuarial underpinnings of the System. City Manager, City Employees Retirement System Proposal at 6 (June 7, 1996). Mr. Hamilton's concerns were not assuaged by this provision, however, as he believed the terminology "extraordinary circumstances" was too ambiguous to provide a practical safeguard. Minutes, SDCERS Board Meeting at 20 (June 11, 1996).

Letter from Dwight Alan Hamilton, Hamilton and Faatz, and John A. Graham, Frandzel & Share, to Lawrence Grissom, Retirement Administrator (June 21, 1996); City Manager, Retirement System Proposal at 7 (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal).

Constitution if it were to approve MP-1 – demonstrably short of an affirmative statement that MP-1 was in keeping with the Board's fiduciary duties. 664

While it is debatable whether the "fix" to MP-1, noted above, was sufficient to address the deficiency noted by Mr. Hamilton, there were more fundamental problems with his advice. First, he simply failed to address perhaps the biggest failing of MP-1: it was illegal under California law. It is unclear why Mr. Hamilton did not address this issue. Mr. Hamilton should have addressed the legal status of MP-1 under the San Diego City Charter and the California Constitution. Second, although Mr. Hamilton did address – in an opinion issued three months after the SDCERS Board approved MP-1 – the apparent conflict of interest presented by the fact that benefit enhancements that would accrue to Board members personally were conditioned on the Board's approval of MP-1, his analysis was superficial, noting merely that the drafters of the City Charter had been well aware that Board members would, in many cases, be members of SDCERS and therefore could be financially interested in the outcomes of the Board's deliberations. This analysis, however, failed to fully address the conflict in the context of the unique facts and circumstances of MP-1.

Robert Blum and Constance Hiatt of the law firm Hanson Bridgett served as the Board's fiduciary counsel with respect to MP-2. If anything, their performance was even worse than Mr. Hamilton's. They appear to have completely abdicated their responsibility to provide competent, independent legal advice to the Board. In first advising the Board against MP-2 and later in reversing course and advising in favor of it, 667 it appears Mr. Blum and Ms. Hiatt were taking an inordinate amount of direction from Mr. Grissom. 668

Letter from Dwight Alan Hamilton, Hamilton and Faatz, and John A. Graham, Frandzel & Share, to Lawrence Grissom, Retirement Administrator (June 21, 1996).

The Reish Luftman Report similarly concluded that Mr. Hamilton failed to adequately consider the underlying legality of MP-1. Reish Luftman Reicher & Cohen, Legal Analysis of Investigative Report on the San Diego City Employees' Retirement System at 73-74 (Jan. 20, 2006). The City Attorney's criticism of the deficiencies in Mr. Hamilton's consideration of MP-1 is generally consistent. City Attorney Michael J. Aguirre, Interim Report No. 6 Regarding the San Diego City Employees' Retirement System Funding Scheme at 41-45 (June 21, 2005). Moreover, the City Attorney found that Mr. Hamilton failed to deliver timely advice to the SDCERS Board about the necessity of examining the City's ability to report the de facto loan SDCERS would be granting it. The City Attorney concluded that Mr. Hamilton's opinion, delivered three months after the Board approved MP-1, came too late: "The the [sic] board conduct [sic] financial due diligence should have been given before the pension board approved MP-1 on 21 June 2002 [sic]." Id. at 45 (emphasis in original). Vinson & Elkins suggested that Hamilton's analysis was incomplete in terms of its analysis of the potential conflicts of interest raised by MP-1. Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Report on Investigation, The City of San Diego, California's Disclosures of Obligation to Fund the San Diego Employees' Retirement System and Related Disclosure Practices 1996–2004 with Recommended Procedures and Changes to the Municipal Code at 51 (Sept. 16, 2004).

Letter from Dwight Alan Hamilton, Hamilton and Faatz, and John A. Graham, Frandzel & Share, to Lawrence Grissom, Retirement Administrator (Sept. 19, 1996).

Letter from Constance M. Hiatt and Robert Blum to Lawrence Grissom, Retirement Administrator (Draft June 12, 2002); Letter from Bob Blum and Connie Hiatt to Frederick W. Pierce, IV, President, Retirement Board (Nov. 18, 2002).

This is not to say there were not revisions to MP-2 between their first and second opinions – there were. But these revisions did not remedy the basic flaw in MP-2, which was the same as that afflicting MP-1: it was illegal under California law. ⁶⁶⁹

Because MP-2 was illegal, and because SDCERS received no benefit from it, the Board could not have approved it without breaching its fiduciary duty to SDCERS.⁶⁷⁰ SDCERS's litigation counsel reached precisely these conclusions in early 2003, after the filing of the *Gleason* litigation.⁶⁷¹ Either Mr. Blum and Ms. Hiatt appreciated the illegality of MP-2 and simply kept silent about it or, inexcusably, failed to understand it. Under either scenario, however, Mr. Blum and Ms. Hiatt's advice was incomplete and inadequate.⁶⁷² While the Audit Committee requested to speak with Mr. Blum and Ms. Hiatt to inquire about, among other things, their understanding of the proposal, they each declined to be interviewed.

E-mail from Sheila Leone to Lori Chapin cc to Roxanne Parks (Mar. 24, 2003); E-mail from Lawrence Grissom to Robert Blum (Oct. 30, 2002); E-mail from Robert Blum to Loraine Chapin, Lawrence Grissom and Paul Barnett cc to Constance Hiatt (Sept. 16, 2002).

Rules of Professional Conduct of the State Bar of California, ch. 3, § 3-210 (stating that an attorney has a duty to advise against violations of the law).

⁶⁷⁰ Mr. Blum and Ms. Hiatt also failed to identify timely the potential conflict of interests affecting the votes of the City employees who served on the SDCERS Board. On July 3, 2002, Mr. Blum advised a union representative that had participated in meet and confer earlier in the year that he could discharge his fiduciary duties to SDCERS by voting on MP-2 so long as he made a "thorough, prudent consideration of the facts" of the proposal in his capacity as a SDCERS Board member. E-mail from Robert Blum to [Tom Rhodes] cc to Connie M. Hiatt, Loraine Chapin, Lawrence Grissom and Paul Barnett (July 3, 2002). However, it appears that Mr. Blum did not conduct independent legal research on the issue until the end of August 2002. E-mail from Loraine Chapin to Robert Blum ce to Lawrence Grissom, Paul Barnett, Roxanne Story Parks and Sheila Leone (Aug. 21, 2002). Moreover, Mr. Blum did not raise the issue of conflicts of interest of City employees sitting on the SDCERS Board until after the July 11, 2002, SDCERS Board vote approving MP-2 and, even then, he only identified Cathy Lexin as having conflicting interests in connection with the proposal. E-mail from Robert Blum to Lawrence Grissom, Paul Barnett and Loraine Chapin cc to Constance Hiatt and Marcus Wu (July 30, 2002); E-mail from Loraine Chapin to Robert Blum cc to Lawrence Grissom, Paul Barnett, Roxanne Story Parks and Sheila Leone (Aug. 21, 2002). Apparently Mr. Blum only came to appreciate the seriousness of this conflict of interest later, when he wrote in a September e-mail to SDCERS staff that attached a draft of his opinion letter: "PLEASE DO NOT give to Cathy Lexin. cathy [sic] and crew will use it to negotiate and i dont [sic] want them to have that advantage. . . cathy [sic] probably will be all over you on Monday to get a copy. DONT [sic] DO IT." E-mail from Robert Blum to Lawrence Grissom, Paul Barnett and Loraine Chapin cc to Connie M. Hiatt (Sept. 22, 2002).

Letter from Reg A. Vitek, Seltzer Caplan McMahon Vitek, to Sheila Leone, Esq., SDCERS cc to Michael A. Leone, Esq. (Mar. 5, 2003).

The legal analysis accompanying the Navigant Report concluded that Mr. Blum's final opinion regarding MP-2 failed to consider the legality of the proposal. Reish Luftman Reicher & Cohen, Legal Analysis of Investigative Report on the San Diego City Employees' Retirement System at 90 (Jan. 20, 2006). The City Attorney discussed at length Mr. Blum's involvement in the negotiation and approval process of MP-2, but did not reach any conclusions regarding his personal responsibility. City Attorney Michael J. Aguirre, Interim Report No. 7 SDCERS Attorney-Client Privilege Documents Released Under Federal Court Order at 9-13, 21-22 (Dec. 6, 2005).

B. The City

1. The City Council

As the legislative branch of the City government, the City Council was a key party in the enactment of MP-1 and MP-2. In 1996 and again in 2002, the City Council voted to approve pension funding arrangements that violated the California Constitution, the City Charter, and the Municipal Code. Despite the plain language of the controlling statutes, and their obligation as elected officials to uphold the laws of the City and State, there is no evidence the Council members ever bothered to inquire whether these agreements were permissible under California law.

It should be noted that the Council members who voted on MP-2 had inherited an already violative system and both they and the predecessor Council that adopted MP-1 were failed by their legal counsel – the City Attorney's Office and outside fiduciary counsel – who did not bring the issue of the legality of these proposals to the Council's attention. This does not change the central fact, however, that the Council's vote in approving both MP-1 and MP-2 resulted in an illegally funded pension system.

2. City Administration

The City and its various offices and employees also bear responsibility for illegalities in connection with the City's pension funding. First, to the extent that the SDCERS Board violated its responsibilities to its members by approving MP-1 and MP-2, overruling Mr. Rick Roeder on the suggested actuarial treatment of the *Corbett* settlement, and allowing the retirement system to become actuarially unsound, the City is responsible for its active encouragement of these unsound practices in order to obtain short-term contribution relief. Second, to the extent the financial condition of the retirement system created reporting obligations for the City, the City is responsible for its failures to satisfy these disclosure requirements.

In the case of MP-1, the relevant City personnel who encouraged the SDCERS Board's breach of fiduciary duty and contributed toward the City's violation of the California Constitution, the City Charter, and the Municipal Code include City Manager McGrory, City Auditor Ryan, and the City representatives on the SDCERS Board: Terri Webster, Sharon Wilkinson, and Bruce Herring. City Manager

San Diego City Council Ordinance O-19121 (Nov. 18, 2002); San Diego, Cal., Ordinance O-18383 (Feb. 25, 1997); Gai v. Fresno City Council, 63 Cal. App. 3d 381, 387 (1976) ("[C]ity charters pertaining to municipal affairs supersede all laws inconsistent therewith."); Acton v. Henderson, 150 Cal. App. 2d 1, 13 (1957) ("We start with the premise that the ordinances . . . of the Municipal Code are invalid if they conflict with the charter . . . section 6 of article XI of the state Constitution so provide[s], and the cases are in accord.").

Cal. Const. arts. XX, § 3; San Diego City Charter art. XIV, § 211.

Jack McGrory pressed the SDCERS Board for contribution relief as early as 1994. He developed the concept that became MP-1 in early 1996, made the original presentation of MP-1 to the SDCERS Board, then presented and defended the final version. At the same time that he was pushing through his agenda at SDCERS for contribution relief for the City, he was spearheading the meet and confer process and keeping the Mayor and Council informed of the progress. Notably, Mr. McGrory knew of both SDCERS's actuary's and outside fiduciary counsel's concerns about MP-1, namely that the proposal would shift current pension costs onto future taxpayers. Mr. McGrory nonetheless advocated for MP-1's adoption.

City Auditor Ed Ryan, while still a member of the SDCERS Board in 1995, advocated for and voted in favor of one-time contribution relief for the City without even waiting for an opinion on the appropriateness of this relief from fiduciary counsel. Fiduciary counsel ultimately objected to this proposal for contribution relief and it was never adopted. Despite the knowledge that SDCERS's fiduciary counsel

In his interview with the Audit Committee, Mr. McGrory described what he believed to be two safeguards built into MP-1. First, he said a reserve was established out of surplus earnings at the time MP-1 was adopted, which reserve was intended to cover the shortfall created by the City's reduced contributions. However, since the "reserve" by definition consisted of the retirement system's own assets, establishing it did not offset or protect against the City underfunding the retirement system. Second, Mr. McGrory described that, in his view, it had always been contemplated that if the City were to increase benefits during the term of MP-1, the City would nonetheless be obligated to increase its contributions to cover those new benefits. Whether or not Mr. McGrory or anyone else actually ever held this belief, the MP-1 agreement does not contain such a requirement and in fact, when new benefits were eventually granted, the City's contributions were not revised upward. Interview by the Audit Committee with Jack McGrory (May 4, 2006).

Memorandum from Jack McGrory, City Manager, to City Employees Retirement System Board of Directors via Larry Grissom, Retirement Administrator (Feb. 17, 1994); Memorandum from Lawrence B. Grissom, Retirement Administrator, to Business and Procedures Committee (May 6, 1994).

E-mail from Jack McGrory to Distribution (Feb. 29, 1996); Memorandum from Larry Grissom to Keith Enerson (Draft Mar. 1, 1996).

Minutes, SDCERS Board Meeting at 1 (May 2, 1996).

Minutes, SDCERS Board Meeting at 12-31 (June 21, 1996).

Memorandum from Jack McGrory, City Manager, to Honorable Mayor and City Council (June 6, 1996); Memorandum from Jack McGrory, City Manager, to Honorable Mayor and City Council (May 15, 1996).

Minutes, SDCERS' Retirement Board of Administration Special Workshop at 16, 22 (June 11, 1996).

According to Robert Scannell, Board Member, he received a call from Mr. McGrory's office to lobby Mr. Scannell to vote in favor of MP-1. Interview by the Audit Committee with Robert Scannell (May 3, 2006). See also Interview by the Audit Committee with Conny M. Jamison (May 9, 2006).

Minutes, SDCERS Special Board Meeting at 10 (Mar. 24, 1995); Minutes, SDCERS Board Meeting at 9 (Feb. 24, 1995).

Letter from Morrison & Foerster to Lawrence B. Grissom, Retirement Administrator (May 9, 1995).

rejected a contribution relief proposal just one year earlier, Mr. Ryan was aware of and made no objection to the adoption of MP-1 which granted the City even greater relief at SDCERS's expense.⁶⁸⁴

Finally, the City representatives to the SDCERS Board who voted to approve MP-1 – Ms. Webster, Ms. Wilkinson, and Mr. Herring, Mr. McGrory's right-hand man⁶⁸⁵ – plainly allowed their loyalties to the City to trump their fiduciary obligations to SDCERS members.⁶⁸⁶

Immediately after the adoption of MP-1, SDCERS and the City were both required to report that the funding mechanism for SDCERS was not approved by the Governmental Accounting Standards Board ("GASB") and to calculate and report, as an NPO, the difference between the payments that the City actually made and the Annual Required Contribution required under a GASB-approved actuarial method. 687 Nevertheless, this obligation was ignored for more than two years. 688

A second and more serious accounting issue arose in connection with the 2000 settlement of the Corbett litigation. Much of the City's payment obligation under this settlement was structured to be "contingent" on the availability of adequate Surplus Earnings, even though the settlement amounts remained absolute obligations whether or not Surplus Earnings were available. The SDCERS Board, despite concern expressed by the actuary Mr. Roeder, voted not to include these "contingent" payments in the pension fund's UAAL. This actuarial treatment had a material negative impact on the financial soundness of the retirement system, because it allowed the system to record a lower UAAL and, accordingly, a higher funded ratio. By so doing, it artificially delayed the point at which the system's funded ratio would fall below the

E-mail from Terri Webster to Jack McGrory (June 21, 1996); Handwritten Notes (May 19, 1996).

While the SDCERS Board was awaiting fiduciary counsel's opinion on one time rate relief in 1995, Mr. Herring wrote to Mr. Grissom, expressing his concern at the delay in receiving the opinion, due to the proposal's "tremendous financial impact of this action so late in the fiscal year." Memorandum from Bruce Herring, Deputy City Manager, to Larry Grissom, Retirement Administrator (Apr. 6, 1995).

Minutes, SDCERS Board Meeting at 31 (June 21, 1996).

Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 § 20(b)(3) (June 30, 2005).

When they began to comply with the reporting requirement, they adopted a 40-year amortization period, rather than the normal 30-year period, for the retirement system's UAAL. While not technically violative of GASB, it was certainly not prudent for the City to adopt an amortization period for purposes of diminishing the value of the reported NPO. The evidence shows that both City Auditor Ryan Ed and Deputy Auditor Terri Webster were actively involved in choosing the 40-year amortization period, which benefited the City at the retirement system's expense. E-mail from Paul Webber to Terri Webster, Ed Ryan and Daniel M. Deaton cc to Paul Webber and Darlene Morrow-Truver (Oct. 8, 2003).

Order and Judgment Approving Settlement of Class Action, Corbett v. City Employees' Retirement System, No. 722449, at 9 (Cal. Super. Ct. Apr. 4, 2000); Minutes, SDCERS Board Meeting at 13 (June 21, 2002).

Minutes, SDCERS Board Meeting at 19 (Feb. 15, 2002); Letter from Rick A. Roeder to Larry Grissom (Mar. 30, 2000).

82.3% trigger and require increased contributions from the City. The retirement system's loss, of course, was the City's gain: the improper treatment of *Corbett* "contingent" liabilities allowed the City, again, to postpone the point at which it would begin to increase its annual payments to SDCERS.

The evidence shows that Ed Ryan, Terri Webster, Lawrence Grissom, Dan Kelley, and Bruce Herring were involved in developing the idea of structuring the *Corbett* settlement to allow room for the argument that these new liabilities did not need to be included in the UAAL and then securing the agreement of the SDCERS Board to treat them this way, despite their own actuary's objection. City employees Terri Webster and Cathy Lexin, in their capacity as SDCERS Board members, also supported this treatment which benefited the City at the expense of the retirement system's members.

Finally, MP-2 is another clear example of the SDCERS Board being induced to take action to benefit the City at the expense of the retirement system members to whom the Board owed a fiduciary duty. The main City proponents of MP-2 were City Manager Uberuaga, Deputy City Manager Bruce Herring, and the City representatives on the SDCERS Board who voted to approve it: Terri Webster and Cathy Lexin. 693

The City Manager's Office was the primary architect and advocate of the MP-2 underfunding proposal. City Manager Uberuaga discussed the concept of MP-2 with the SDCERS Board in May 2002,⁶⁹⁴ then submitted two memoranda explaining the proposal in June.⁶⁹⁵ Deputy City Manager Bruce Herring made presentations to the SDCERS Board advocating MP-2 in June and July,⁶⁹⁶ and, through

Memorandum from Bruce A. Herring, Deputy City Manager, to Honorable Mayor and Councilmembers (Apr. 13, 2000); Memorandum from City Auditor and Comptroller to Honorable Mayor and City Council cc to Michael Uberuaga, City Manager, and Bruce Herring, Deputy City Manager (Apr. 11, 2000); E-mail from Terri Webster to Bruce Herring cc to Dan Kelley and Ed Ryan (Apr. 6, 2000); Letter from Rick A. Roeder to Larry Grissom (Mar. 30, 2000); Handwritten Notes of Cathy Lexin (Feb. 8, 2000).

Minutes, SDCERS Board Meeting at 11 (June 21, 2002); Minutes, SDCERS Business Procedures Committee Meeting at 6 (Feb. 15, 2002); Minutes, SDCERS Business Procedures Committee Meeting at 4 (Mar. 16, 2001).

Minutes, SDCERS Board Meeting at 38 (July 11, 2002); Minutes, SDCERS Board Meeting at 30 (Nov. 15, 2002). Only after the critical vote approving MP-2 in July, Cathy Lexin acknowledged that she faced a potential conflict of interest and recused herself from the November vote.

Minutes, SDCERS Special Board Meeting at 35-37 (May 29, 2002).

Memorandum from Michael T. Uberuaga, City Manager, to San Diego City Employees' Retirement System (SDCERS) Board of Administration via Lawrence B. Grissom, Retirement Administrator (June 10, 2002); Memorandum from Michael T. Uberuaga, City Manager, to San Diego City Employees' Retirement System (SDCERS) Board of Administration via Lawrence B. Grissom, Retirement Administrator (June 18, 2002).

Minutes, SDCERS Board Meeting at 16 (June 21, 2002); Minutes, SDCERS Board Meeting at 2 (July 11, 2002).

memoranda he authored and submitted to the Board, attempted to allay the concerns expressed about the proposal. 697

Like City Manager McGrory before him, City Manager Uberuaga, as the chief administrative officer of the City, was responsible to the citizens of San Diego to perform diligently and competently in that office, and to supervise adequately the employees working beneath him. In advocating the intentional underfunding of the pension system through MP-1 and MP-2, City Managers McGrory and Uberuaga failed to act in the best interests of the City and did not meet the standards expected of public servants.

The record shows that Ms. Webster and Ms. Lexin, through information they received both as City employees and as members of the SDCERS Board, were keenly aware of the financial implications to the City if the MP-1 trigger were to be breached and of the critical role played by MP-2 in either forestalling this event (the original version of MP-2 would have reduced the funded ratio trigger to 75%) or mitigating its impact. Indeed, in January 2002, Terri Webster sent an e-mail to Ed Ryan, which stated that the sharp decline in SDCERS investment earnings raised "SERIOUS consequences and needs attention" and needed to be discussed by Ms. Lexin in a briefing with Mr. Grissom. Ms. Webster, one month later, asked Ms. Vattimo to direct Mr. Roeder to estimate the funded ratio, warning that "[t]he 82% trigger point is looking WAY too close." Despite this knowledge, they voted, as SDCERS trustees, to approve MP-2.

Securing the SDCERS Board's approval of MP-2 required not merely the application of general political pressure, but also, in the case of Firefighters Union President and SDCERS Board member Ronald Saathoff, the specific financial inducement of a Presidential Leave benefit that increased his pension in a single stroke by approximately \$30,000 per year.⁷⁰² The evidence shows that City officials Terri Webster,

Memorandum from Bruce Herring, Deputy City Manager, to Lawrence B. Grissom, Retirement Administrator (July 1, 2002); Memorandum from Bruce Herring, Deputy City Manager, to Lawrence B. Grissom, Retirement Administrator (July 3, 2002).

E-mail from Terri Webster to Elmer Heap and Michael Rivo cc to Cathy Lexin (Apr. 17, 2002); E-mail from Byron Wear to Cathy Lexin, Brian Maienschein, Donna Frye, George Stevens, Jim Madaffer, Ralph Inzunza, Scott Peters, Councilmember Atkins, and Dick Murphy (June 23, 2002); Minutes, SDCERS Special Board Meeting (May 29, 2002); Minutes, SDCERS Board Meeting (June 21, 2002); Minutes, SDCERS Board Meeting (July 11, 2002); Minutes, SDCERS Board Meeting (Nov. 15, 2002).

E-mail from Terri Webster to Ed Ryan (Jan. 3, 2002).

E-mail from Terri Webster to Mary Vattimo (Feb. 12, 2002).

Minutes, SDCERS Board Meeting at 38 (July 11, 2002); Minutes, SDCERS Board Meeting at 30 (Nov. 15, 2002).

Declaration of San Diego Labor Relations Manager Scott Chadwick in Support of Defendants' and Cross-Complainants' San Diego City Attorney Michael J. Aguirre and the City of San Diego's Motion for Summary Judgment or in the Alternative Motion for Summary Adjudication at 2, 7, San Diego City Employees' Ret. Sys. v. Aguirre, No. GIC 841845 (Cal. Super. Ct. Mar. 15, 2006) (stating that Mr. Saathoff's retirement benefit increased by \$2,531.00 per month as a result of the implementation of the Presidential Leave benefit in 2002); San Diego City

Ed Ryan, Cathy Lexin, and Dan Kelley and SDCERS Administrator Lawrence Grissom were involved in proposing and obtaining this special benefit for Mr. Saathoff, in apparent exchange for his support for MP-2.703

An individual aids and abets a breach of fiduciary duty if he "(a) knows the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other to so act or (b) gives substantial assistance to the other in accomplishing a tortious result and the person's own conduct, separately considered, constitutes a breach of duty to the third person." City officials and employees, through their actions regarding MP-1, Corbett, and MP-2, applied a tremendous amount of pressure on fiduciaries, demonstrating a severe lack of judgment and a desire to seek a quick fix at the expense of the long-term welfare of SDCERS. However, this conduct alone is insufficient to satisfy the legal standard of aiding and abetting. While there is an abundance of evidence that City officials "substantially assisted" SDCERS Board members in breaching their fiduciary duty to plan participants, there is no evidence that these officials and employees either knew they caused others to breach their duties, or that their own conduct constituted a separate breach of a legal duty. While City officials clearly acted improperly in both causing the City to

Council Resolution No. R-297212 (Oct. 21, 2002); E-mail from Terri Webster to Mike McGhee (May 21, 2002); Memorandum on Local 145 High One Year Calculation (Nov. 5, 2001); E-mail from Judy Zellers to Larry Grissom cc to Cathy Lexin and Terri Webster with attached Presidential Leave calculation (Sept. 20, 2001).

E-mail from Dan Kelley to Ron Saathoff, jeffnoffa@aol.com, 1MM@sandiego.gov (July 30, 2002); E-mail from Cathy Lexin to Larry Grissom (June 25, 2002); Memorandum from Cathy Lexin, Human Resources Director, and Elmer Heap, Head Deputy City Attorney, to Honorable Mayor and City Council (June 13, 2002); E-mail from Terri Webster to Mike McGhee (May 21, 2002); Memorandum from Cathy Lexin, Human Resources Director, to Honorable Mayor and City Council (Nov. 26, 2001).

Casey v. U.S. Bank Nat'l Ass'n, 127 Cal. App. 4th 1138, 1144-45 (2005). The City Attorney did not address the legal standard for aiding and abetting a breach of another's fiduciary duty, but otherwise concluded that, in connection with MP-1, a number of City officials—most notably, City Manager Jack McGrory—breached fiduciary duties owed directly to plan participants. The City Attorney alternatively concluded that even if City officials did not owe plan participants fiduciary duties, those officials arguably triggered such fiduciary obligations by making representations about the appropriateness of the changes to MP-1. City Attorney Michael J. Aguirre, Amended Interim Report No. 6 Regarding the San Diego City Employees' Retirement System Funding Scheme at 17-18, 20-21 (July 1, 2005). The City Attorney's conclusions, however, were based on analogy to ERISA case law which held that an employer was a fiduciary under ERISA where it also acted as an administrator, and where the plan documents did not specify a different administrator. Kendal Corp. v. Inter-County Hospitalization Plan, Inc., 771 F. Supp. 681 (E.D. Pa. 1991). This is in contrast to the situation here, where City officials were not acting as administrators of the retirement system and the City Charter expressly provided that the SDCERS Board has sole administrative responsibility for SDCERS. Furthermore, ERISA, by its own terms, is explicitly not binding on public retirement systems. 29 U.S.C. § 1003(b)(1) (West 2006). Vinson & Elkins did not specifically address the issue of City officials' potential responsibility for inducement of the Board's breach of its fiduciary duties by entering into MP-1 and MP-2.

While City officials and employees have general responsibilities to the public, they do not have a specific and independent fiduciary responsibility to plan participants, as does the SDCERS Board. Clark v. City of Hermosa Beach, 48 Cal. App. 4th 1152, 1170 (Cal. Ct. App. 1996) (stating that this duty requires public officials to exercise their powers with "disinterested skill, zeal, and diligence and primarily for the benefit of the public.").

adopt an illegal funding scheme and influencing others to breach their fiduciary duties, there is insufficient evidence that they did so knowingly or that their conduct was itself a separate breach of duty.⁷⁰⁶

3. City Attorney's Office

As with SDCERS General Counsel Lori Chapin, the City Attorney's Office was not actively involved in promoting violations of law or duty in connection with MP-1 and MP-2 but failed, in its watchdog role, to identify and prevent these violations.

As we have seen, City Attorney John Witt recused himself from considering MP-1, citing a potential conflict of interest because he would personally benefit from MP-1 when he retired, as planned in the near future. The Mr. Witt noted that MP-1 raised "important fiduciary considerations which must be fully examined. The Mr. Whether or not it was appropriate for Mr. Witt to recuse himself, it remained the responsibility of the City Attorney's Office, either directly or through a legal analysis commissioned from an outside law firm, to fully explore both the "fiduciary concerns" to which Mr. Witt alluded and the legality of MP-1 under the California Constitution, the City Charter, and the Municipal Code. None of this was done. Nor did Mr. Witt even consider whether the potential conflict that led to his own recusal would similarly affect the Board members who would, in effect, be voting on their own benefit increases. The City Attorney's Office performed no analysis whatsoever of MP-1, and outside counsel produced only a superficial analysis of the fiduciary obligations of the City and SDCERS Board, without addressing the inherent legality of MP-1 or the conflicts issues it raised. The City and SDCERS Board, without addressing the inherent legality of MP-1 or the conflicts issues it raised.

With respect to MP-2, individuals in the City Attorney's Office were involved with the meet and confer process and the City's proposals to SDCERS. Elmer Heap, Head Deputy City Attorney in the City Attorney's Office, was part of the City's negotiating team in the 2002 meet and confer process, 710 was

As mentioned at the beginning of this Report, it is worth noting that the focus of the Audit Committee's investigation was not the same as those of the investigations performed by the federal or state prosecutors, who indicted certain individuals on criminal charges. The conclusions reached by this Report are not intended to exonerate any individuals from pending or future prosecutions.

John W. Witt, City Attorney, Report to the Board of Administration for the San Diego City Employees' Retirement System (Apr. 23, 1996).

John W. Witt, City Attorney, Report to the Board of Administration for the San Diego City Employees' Retirement System (Apr. 23, 1996).

Letter from Jeffrey S. Leavitt to Bruce A. Herring, Deputy City Manager (Apr. 29, 1996).

Memorandum from Cathy Lexin, Human Resources Director, and Elmer Heap, Head Deputy City Attorney, to Honorable Mayor and City Council (June 14, 2002); Memorandum from Cathy Lexin, Human Resources Director, and Elmer Heap, Chief Deputy City Attorney, to Mayor and City Council (June 6, 2002).

fully apprised of SDCERS's progress in considering and approving MP-2,⁷¹¹ and negotiated the actual language of MP-2 with SDCERS fiduciary counsel Robert Blum.⁷¹² In addition, Mike Rivo, Deputy City Attorney, was also involved in drafting the agreement between the City and SDCERS, and similarly neglected to advise either party about any potential illegality.⁷¹³ Both Mr. Heap and Mr. Rivo reported to then-City Attorney Casey Gwinn.

Despite the close involvement of the City Attorney's Office in the development and approval of MP-2, no one from that Office at the time appears to have given any consideration to the question of MP-2's legality. No analysis was performed regarding the numerous conflict issues, especially those involving Ronald Saathoff, created by the votes of various SDCERS Board members, the general propriety of linking the City's granting of retirement benefits to SDCERS's acquiescence in direct or indirect contribution relief, or the legality of MP-2 under the California Constitution, the City Charter, or the Municipal Code. One of the principal functions of the City Attorney's Office is to ensure that the City acts at all times in compliance with law. In the case of MP-1 and MP-2, the City Attorney abdicated this responsibility, choosing instead to sit on the sidelines.

E-mail from Terri Webster to Ed Ryan and Dan Kelley cc to Bob Lawrence, Bob Wilson, and Elmer Heap (May 21, 2002). Mr. Heap attended the June 21, 2002 SDCERS Board meeting in which a revised MP-2 proposal was discussed. Minutes, SDCERS Board Meeting at 1, 16-32 (June 21, 2002).

E-mail from Robert Blum to Elmer Heap and Mike Rivo (Oct. 16, 2002).

E-mail from Robert Blum to Elmer Heap and Mike Rivo (Oct. 16, 2002). Mr. Rivo attended the May 29, 2002 SDCERS Board meeting, in which MP-2 was first proposed. Minutes, SDCERS Board Meeting at 1, 35-37 (May 29, 2002).

EXHIBIT 10

NOT TO BE PUBLISHED IN OFFICIAL REPORTS

California Rules of Court, rule 8.1115(a), prohibits courts and parties from citing or relying on opinions not certified for publication or ordered published, except as specified by rule 8.1115(b). This opinion has not been certified for publication or ordered published for purposes of rule 8.1115.

COURT OF APPEAL, FOURTH APPELLATE DISTRICT

DIVISION ONE

STATE OF CALIFORNIA

JOHN A. TORRES et al.,

D049111

Plaintiffs and Respondents,

v.

(Super. Ct. No. GIC852293)

CITY OF SAN DIEGO,

Defendant and Appellant;

BRUCE HERRING,

Intervener and Respondent.

APPEAL from an order of the Superior Court of San Diego County, Linda B. Quinn, Judge. Dismissed in part; affirmed in part.

Plaintiffs, John A. Torres, Ronald L. Saathoff, Cathy Lexin, Terri A. Webster, Sharon K. Wilkinson and Mary Vattimo, and plaintiff-in-intervention, Bruce Herring, are former members of the Board of Administration of the San Diego City Employees'

Retirement System (SDCERS). 1 The board members sued the City of San Diego (City) for specific performance and declaratory relief, alleging that under a City resolution and Government Code section 995 the City was required to pay for their defense in a civil action the San Diego City Attorney, Michael Aguirre, filed against them on behalf of the People of California, and in another civil action in which he filed a cross-complaint against them on behalf of the City. The board members obtained summary judgment against the City. The City filed a late notice of appeal and we dismissed the matter.

Subsequently, the trial court issued an order awarding the board members attorney fees incurred in this action, under the City's resolution. The City has timely appealed the order, but also purports to raise issues pertaining to the summary judgment. We dismiss the appeal to the extent it concerns the summary judgment ruling as we lack jurisdiction to consider it. We affirm the order on the attorney fees incurred in this action.

FACTUAL AND PROCEDURAL BACKGROUND

In July 2005, Aguirre, on behalf of the People of the State of California, filed a first amended complaint against the board members (with the exception of Vattimo) for the recovery of economic benefits wrongly received and injunctive relief under the Political Reform Act of 1974, as amended. (*People v. Grissom* (Super. Ct. San Diego County, 2005, No. GIC850246).) The complaint alleged that in 1996, in connection with their service with SDCERS, the board members violated conflict of interest laws by

¹ For convenience we refer to the plaintiffs and the plaintiff-in-intervention as board members.

voting to increase employee pension benefits without providing the required funding, thereby creating an "unfunded liability . . . for which the City . . . was to be responsible and for which revenues from future years would pay."

Also in July 2005, Aguirre, on behalf of the City, filed a cross-complaint against the board members for declaratory relief, breach of trust, breach of fiduciary duty, fraud, negligence and conspiracy. The underlying complaint was by SDCERS against Aguirre and the City. The cross-complaint alleged the same misconduct as alleged in *People v*. *Grissom*, and added that the board members violated Government Code section 1090, which prohibited them from taking action on contracts in which they had a financial interest. (*SDCERS v. Aguirre*, Super. Ct. San Diego County, 2005, No. GIC841845.) The record contains no evidence the San Diego City Council (City Council) approved Aguirre's filing of either of these civil actions.

In 2002 the City Council had unanimously adopted a resolution designated R-297335. The resolution's preamble explains that SDCERS board members "may, from time to time be subjected to claims and suits for actions taken in [that] capacity," and "there is a need to protect and encourage individuals who volunteer their time and their talent to serve in the public interest." The resolution provides that "the City shall defend, indemnify and hold harmless all past, present and future members of the Retirement Board against all expenses, judgments, settlements, liability and other amounts actually and reasonably incurred by them in connection with any claim or lawsuit arising from any act or omission in the scope of the performance of their duties as Board Members."

The board members tendered the defense of the two civil actions to the City based on the resolution and Government Code section 995.² That created an unusual situation, of course, as Aguirre, the City Attorney, filed the actions and the provision of a defense would require the City to pay both prosecution and defense costs.

The City Council sought legal advice on the matter from the law firm Procopio Cory Hargreaves & Savitch, LLP (Procopio). In a July 2005 memorandum that was later publicly released, Procopio concluded the City was obligated to provide the board members a defense in the two civil actions, notwithstanding the City Attorney's role in the lawsuits. The following month the City Council voted 4 to 2 to provide a defense, but a vote of five was required to carry the matter. The board members thus retained their own defense counsel.

In August 2005, the board members, excluding Herring, sued the City for specific performance and declaratory relief, seeking a defense in the civil actions based on Resolution R-297335 and Government Code section 995. Herring filed a complaint-in-intervention against the City for the same relief.

The board members filed a motion for summary judgment. After a January 2006

Government Code section 995 provides: "Except as otherwise provided in Sections 995.2 and 995.4, upon request of an employee or former employee, a public entity shall provide for the defense of any civil action or proceeding brought against him [or her], in his [or her] official or individual capacity or both, on account of an act or omission in the scope of his [or her] employment as an employee of the public entity. [¶] For the purposes of this part, a cross-action, counterclaim or cross-complaint against an employee or former employee shall be deemed to be a civil action or proceeding brought against him [or her]."

hearing, the court confirmed its tentative ruling granting the motion on the grounds that under resolution R-297335 and Government Code section 995 the board members are entitled to recover from the City all attorney fees and costs incurred in the two civil actions. Under Government Code section 995, the duty to defend is mandatory unless the public entity finds any of the following: "(1) The act or omission was not within the scope of his or her employment. $[\P]$ (2) He or she acted or failed to act because of actual fraud, corruption, or actual malice. [¶] The defense of the action . . . by the public entity would create a specific conflict of interest between the public entity and the employee or former employee." (Gov. Code, § 995.2, subd. (a).) Government Code section 995.2, subdivision (c) "appears to have been intended to allow a public entity to withdraw from the defense of an employee in conflict of interest situations because it is unreasonable to require a public entity to finance litigation directed against it." (Stewart v. City of Pismo Beach (1995) 35 Cal.App.4th 1600, 1606.) The board members submitted undisputed evidence, however, that the City Council never made any finding under Government Code section 995.2.

The court also determined that in a later noticed motion the board members could request attorney fees incurred in this action. The judgment, entered on March 6, 2006, contained blank spaces for the later entry of the amounts of fees and costs each board member incurred in this action.

The following May 10, the City filed a notice of appeal of the judgment, *Torres v. City of San Diego*, D048687. Torres filed a motion to dismiss and the City filed opposition to the motion. We dismissed the appeal as untimely on June 1.

In June 2006 the City Attorney's Office served on the parties a request to dismiss the board members from the cross-complaint in the *SDCERS v. Aguirre* action. In October the City Attorney's Office filed a request to dismiss the complaint in *People v. Grissom*, and a dismissal was entered. When that case was dismissed, the court was considering a motion by board member Lexin to disqualify the City Attorney's Office from representing the People based on conflicts of interest such as its provision of legal advice to Lexin regarding the subject matter of the lawsuit.³

The board members then moved for attorney fees incurred in this action. The motion was supported by declarations from the board members' attorneys attesting to the amount of fees and costs incurred, and by detailed time entries.

The City opposed the motion on the ground attorney fees are not authorized by contract, statute or law. The City argued that neither resolution R-297335 nor Government Code section 995 provide for the recovery of fees by the prevailing party in an action to obtain a defense or indemnity. The City did not contest the amount or reasonableness of the fees requested.

In reply, the board members argued the plain language of the resolution entitles them to attorney fees incurred in enforcing the City's duty under the resolution to provide them with a defense in the underlying civil actions. The hearing was originally scheduled for June 2, 2006, but the court continued it to June 23 to allow the City "to provide

We have taken judicial notice of these documents in the *People v. Grissom* superior court file. (Evid. Code, §§ 452, subd. (d), 459, subd. (a).)

supplemental briefing on whether . . . Resolution R-297335 provides a legal basis for an award of attorney's fees" to the board members. Originally, the board members sought attorney fees under Government Code section 800 and Code of Civil Procedure section 128.5.

On June 23, the court issued an order that granted the motion for fees on the basis of the resolution. The court awarded the board members various amounts for fees and costs incurred in this action, totaling \$182,342.50 and \$6,176.16, respectively, and the individual awards were added to the judgment. The City timely appealed the June 23 order.

DISCUSSION

Ι

Motion to Dismiss

Α

The board members have moved to dismiss the City's appeal insofar as it purports to raise issues pertaining to the summary judgment, which the City did not timely appeal. The City counters that the court's June 23, 2006 order on attorney fees "substantially and materially altered" the judgment, thus beginning anew the time within which to appeal. The City asserts the board members were not entitled to summary judgment because they did not plead or prove the essential elements of a claim for specific performance and Government Code section 995 provides no basis for declaratory relief or specific performance.

Unless otherwise provided by law, a notice of appeal must be filed on or before the earliest of three dates: (1) 60 days after the court clerk serves a notice of entry of judgment or a file-stamped copy of the judgment on the appealing party, (2) 60 days after the appealing party serves or is served by the opposing party with a notice of entry of judgment, or (3) 180 days after entry of judgment. (Cal. Rules of Court, rule 8.104(a).)
"If a notice of appeal is filed late, the reviewing court must dismiss the appeal." (*Id.*, rule 8.104(b).)

"The effect of an amended judgment on the appeal time period depends on whether the amendment substantially changes the judgment or, instead, simply corrects a clerical error." (Eisenberg et al., Cal. Practice Guide: Civil Appeals & Writs (The Rutter Group 2006) ¶ 3:56, pp. 3-24 to 3-25.) "When the trial court amends a nonfinal judgment in a manner amounting to a substantial modification of the judgment (e.g., on motion for new trial or motion to vacate and enter different judgment), the amended judgment supersedes the original and becomes the appealable judgment (there can only be one 'final judgment' in an action . . .). Therefore, a new appeal period starts to run from notice of entry or entry of the amended judgment." (Id., ¶ 3:56.1, p. 3-25.) "For example, an order amending a judgment to reflect the correct name of a party . . . substantially changes the judgment and therefore starts a new appeal time period (for an appeal from the amended judgment)." (Id., \P 3:56.1a, p. 3-25.) The City relies on CC-California Plaza Assocs. v. Paller & Goldstein (1996) 51 Cal.App.4th 1042, 1049, in which the court explained, "we cannot imagine a more substantial or material change in the form of a judgment than in the identity of the losing party."

It is well settled, however, that "[w]here the judgment is modified merely to add costs, attorney fees and interest, the original judgment is not substantially changed and the time to appeal it is therefore not affected." (Eisenberg et al., Cal. Practice Guide: Civil Appeals & Writs, *supra*, ¶ 3:56:3, p. 3-26; *Amwest Sur. Ins. Co. v. Patriot Homes, Inc.* (2005) 135 Cal.App.4th 82, 84, fn. 1.) "When a party wishes to challenge both a final judgment *and* a postjudgment costs/attorney fee order, the normal procedure is to file *two separate appeals*: one from the final judgment, and a second from the postjudgment order." (Eisenberg et al., *supra*, ¶ 2:156.1, p. 2-73.)

The June 23, 2006 order on attorney fees and costs did not amend the March 6, 2006 judgment in any substantive way. Rather, the judgment was merely modified to add the fees and costs awards. Accordingly, we lack jurisdiction to consider any aspect of the summary judgment ruling.

В

The City contends the modification of the March 6, 2006 judgment to add attorney fees and costs was a "material and substantial" change, since the spaces left on the judgment for the later entry of fees were supposed to be for fees the board members incurred in defending the two underlying civil actions. The City complains that "[i]nstead of moving to insert the attorney's fees and costs incurred in the *other two lawsuits* . . . , [the board members] applied for an award of the fees and costs they incurred in the *current lawsuit*," and that action "left them hoist[ed] on their own petard." (Boldface omitted.) The City is incorrect, as the judgment stated the blank spaces were for fees "incurred in *this* action." (Italics added.) As discussed, the addition to the

judgment of attorney fees and costs awarded in a postjudgment order does not constitute a substantial change in the judgment for purposes of the notice of appeal deadline.

We also reject the City's argument the judgment was substantially changed because the basis for attorney fees in this action was not "an undisputed statute or contract," but resolution R-297335, which raised "new legal issues." The City points out that in their complaint the board members prayed for attorney fees under Government Code section 800 and Code of Civil Procedure section 128.5, rather than under the resolution. The legal basis for a fee award, however, is reviewed in the appeal from the order awarding fees; it does not resurrect a stale appeal of the judgment. The legal basis for the award has nothing to do with the propriety of the underlying summary judgment.

Further, the City's cursory assertion the court denied it due process is unfounded. In its opposition to the motion for attorney fees, the City raised the resolution, arguing it does not provide a basis for an award of fees in this action. When the board members claimed in their reply that the resolution does entitle them to fees, the court continued the hearing for three weeks to give the City the opportunity for further briefing. The City cites no authority for the notion it did not receive a fair hearing and opportunity to be heard on the matter.

Lastly, the City's reliance on *Stone v. Regents of University of California* (1999) 77 Cal.App.4th 736 (*Stone*), is misplaced. In *Stone*, the Regents of the University of California (Regents) appealed a judgment directing a writ of mandate issue to compel them to provide a defense to a physician (Stone) in an underlying civil action against him. Stone moved to dismiss the appeal as untimely. The trial court had ruled the Regents

acted arbitrarily in refusing to defend Stone, and granted a petition requiring them to provide him a defense from May 25, 1995. Judgment was initially entered on March 25, 1996. The Regents successfully moved for reconsideration, and on May 15, 1996, a new judgment was entered, identical to the first but directing them to pay for Stone's defense from March 25, 1996. Stone then moved for reconsideration, and the trial court modified the judgment to require the Regents to pay his defense from June 12, 1995. On July 26, 1996, notice of entry was served on the Regents, and they filed a notice of appeal on August 9 from the judgment as modified. (*Id.* at p. 743.)

The appellate court held the appeal was timely, explaining the "July 22, 1996, amendment was undeniably one of substance The modification required the Regents to pay Stone's legal expenses for an additional nine months. That materially affected their rights. While the Regents would have been prudent to file a timely notice of appeal from the original judgment, just in case, Stone's partial victory on his motion for reconsideration saved the day for them." (*Stone, supra,* 77 Cal.App.4th at p. 744.)

Stone is not "practically on all fours with this case," as the City asserts, as it does not concern a postjudgment award of attorney fees incurred in bringing that action.

Rather, that case concerns a change in the terms of the judgment requiring the Regents to defend Stone in an underlying action. Here, in contrast, the court's June 23, 2006 order did not alter the terms of the summary judgment. Stone is inapplicable.

Attorney Fees Under Resolution R-297335

Attorney fees are allowed as costs to the prevailing party when authorized by any of the following: contract, statute or law. (Code Civ. Proc., §§ 1032, subds. (a)(4) & (b), 1033.5, subd. (a)(10); Civ. Code, § 1717.) "Except as attorney's fees are specifically provided for by statute [e.g., Code Civ. Proc., § 1033.5, subd. (a)(10)], the measure and mode of compensation of attorneys . . . is left to the agreement . . . of the parties." (Code Civ. Proc., § 1021.) The legal basis for an award of attorney fees is a question of law we review independently. (*Leamon v Krajkiewcz* (2003) 107 Cal.App.4th 424, 431.)

The City contends that because R-297335 does not expressly state fees shall be awarded the "prevailing party" in any action to enforce the resolution, the fee award here is improper. The City relies on *Hillman v. Leland E. Burns, Inc.* (1989) 209 Cal.App.3d 860 (*Hillman*), and *Otis Elevator Co. v. Toda Const. of California* (1994) 27 Cal.App.4th 559 (*Otis*), which are in a line of cases holding attorney fees are not available in the prosecution of an indemnity action absent clear language in the indemnity agreement stating the parties contemplated an award of fees for enforcing the agreement. (*Otis*, at p. 566.)

In *Otis, supra,* 27 Cal.App.4th 559, the court, following the reasoning of *Hillman* and related cases, held that "[b]ecause the indemnity agreement at issue here did not explicitly provide for attorney fees incurred in pursuing an indemnity claim against [the indemnitor], [the indemnitee] was not entitled to them. The attorney fee award must therefore be amended to reflect only those fees incurred in the [underlying third party]

personal injury action." (*Id.* at p. 566.) The pertinent question under the *Hillman* line of cases is whether the indemnity provision contains language "which reasonably can be interpreted as addressing the issue of an action between the parties on the contract." (*Building Maintenance Service Co. v. AIL Systems, Inc.* (1997) 55 Cal.App.4th 1014, 1030; *Continental Heller Corp. v. Amtech Mechanical Services, Inc.* (1997) 53 Cal.App.4th 500, 509.)

In Otis, supra, 27 Cal. App. 4th at page 564, the subcontract between the parties provided indemnity for "'all liability, charges, penalties, fines, costs, fees, losses, damages, expenses, causes of action, claims, suits, settlements, awards and judgments (including reasonable attorney's fees) resulting from injury or death sustained by any person . . . which injury, death or damage arises out of, or is in any way connected with, or incidental to the performance of the work under this Subcontract.' " (Italics added.) The court rejected the notion the clause covered attorney fees incurred in litigating the indemnity claim, as the "subcontract permits recovery of expenses, including attorney fees, incurred in defense of any third party claims arising out of Otis's [indemnitor] performance of the work promised in the subcontract. . . . The provision does not specifically state . . . that Toda [indemnitee] would be entitled to such fees in an action to enforce the indemnity provision of the subcontract." (Otis, supra, at p. 564.) The indemnity clause in *Hillman* was similar to that in *Otis*. (*Hillman*, *supra*, 209 Cal.App.3d at p. 866.)

This action does not concern an indemnity contract between the parties, but a public agency resolution. "A decision is authority only for the point actually passed on

by the court and directly involved in the case. General expressions in opinions that go beyond the facts of the case will not necessarily control the outcome in a subsequent suit involving different facts." (Gomes v. County of Mendocino (1995) 37 Cal.App.4th 977, 985; Chevron U.S.A., Inc. v. Workers' Comp. Appeals Bd. (1999) 19 Cal.4th 1182, 1195.)

The construction of a municipal resolution is governed by the rules that govern construction of statutes. (Atchley v. City of Fresno (1984) 151 Cal.App.3d 635, 647.)

The "primal principle of statutory construction requires the ascertainment of the intent of the legislative body [citations] When . . . there is no direct evidence of the legislative intent, the court turns first to the words of the enactment for the answer and may also rely upon extrinsic aids [citations], including recitals and findings in the enactment." (County of Madera v. Superior Court (1974) 39 Cal.App.3d 665, 668-669, italics added.)

Resolution R-297335 requires that the City "defend, indemnify and hold harmless all past, present and future members of the Retirement Board against *all expenses*, judgments, settlements, liability and *other amounts* actually and reasonably incurred by them *in connection with any claim or lawsuit arising from any act or omission in the scope of the performance of their duties as Board Members*." (Italics added.) To any extent that language, standing alone, could be construed to cover only attorney fees incurred in underlying third party suits, such a construction is belied by the City Council's declared intent in passing the resolution: it did not want any of the 13 members of the SDCERS Board of Administration to incur attorney fees associated with any litigation pertaining to the discharge of their duties. Again, the resolution's preamble explains

"there is a need to *protect* and *encourage* individuals who volunteer their time and their talent to serve in the public interest." (Italics added.) Board members would obviously not be protected or encouraged to serve if they were required to incur substantial attorney fees and costs to enforce the City's duty of defense under the resolution.

We acknowledge that the situation here is unusual since the defense obligation arose in conflict of interest actions filed by the City Attorney's Office, and in passing resolution R-297335 the City Council likely did not foresee this situation. The City Council, however, never made any finding of wrongdoing on the board members' part that may have excused the City from its defense obligation. (See Gov. Code, § 995.2; *Stewart v. City of Pismo Beach, supra,* 35 Cal.App.4th at p. 1606.) Contrary to Aguirre's position in this appeal, his filing of the underlying civil actions is not tantamount to the City Council making a finding of wrongdoing, particularly since there is no evidence the City Council even approved of his filing of the actions. Further, Aguirre dismissed the civil actions against the board members before any findings on the merits were made, and thus there was no showing of any actual conflict of interest. Under all the circumstances, we agree with the trial court's assessment that resolution R-297335 entitles the board members to attorney fees and costs incurred in this action.

DISPOSITION

The appeal is dismissed to the extent it	purports to appeal issues pertaining to the
summary judgment. In all other respects, the	June 23, 2006 order awarding attorney fees
and costs is affirmed.	
	McCONNELL, P. J.
WE CONCUR:	
BENKE, J.	
McINTYRE, J.	